

No. 15587

United States
Court of Appeals
for the Ninth Circuit

JOHN COSTELLO, Trustee in Bankruptcy of
Leonard Plumbing and Heating Supply, Inc.,
bankrupt, Appellant,

vs.

J. A. FAZIO and LAWRENCE C. AMBROSE,
Appellees.

Transcript of Record

Appeal from the United States District Court for the
Northern District of California,
Southern Division

FILED

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PAUL P. O'BRIEN, CLERK

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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In the Southern Division of the United States District Court, Northern District of California

No. 43763—In Bankruptcy

In the Matter of

LEONARD PLUMBING AND HEATING SUPPLY, INC., a California corporation.

REFEREE'S CERTIFICATE ON PETITION FOR REVIEW OF ORDER OVERRULING TRUSTEE'S OBJECTIONS TO PROOFS OF CLAIM OF J. A. FAZIO AND L. C. AMBROSE

The undersigned, one of the Referees in Bankruptcy to whom the above-entitled proceedings has been duly referred, in accordance with the provisions of Section 39(c) of the Bankruptcy Act, hereby certifies as follows:

Statement of Proceedings

The above-entitled proceedings were commenced on the 8th day of October, 1954 by the filing herein of a voluntary petition in bankruptcy, upon which an Order of adjudication and reference to the undersigned was herein made on or about said date. Thereafter, and within the time allowed by law, therefor, one J. A. Fazio and one L. C. Ambrose filed herein their Proofs of Claim in the respective sums of \$34,147.55 and \$7,871.17. Thereafter, and on or about the 20th day of December, 1955, said Trus-

tee filed herein his Objections to the said Proofs of Claim filed herein by said J. A. Fazio and L. C. Ambrose, wherein said Trustee prayed that this Court decree the claims of said creditors to be inferior in right to the interests of the other general unsecured creditors of the above-named Bankrupt in any distribution to unsecured creditors of the assets of said Bankrupt in these proceedings.

Thereafter, upon due notice of the hearing of said Trustee's Objections to the said claims, hearings were had thereon before the undersigned Referee in Bankruptcy on the 17th day of January, 1956, on the 25th day of January, 1956, and on the 13th day of February, 1956. At said hearings, Claimant J. A. Fazio was represented by Messrs. Shapro & Rothchild (Arthur P. Shapro, Esq., appearing), his attorneys, and said L. C. Ambrose was represented by Hon Chew, Esq., his attorney, and said Trustee was represented by Messrs. Francis P. Walsh and Stuart R. Dole.

Evidence, both oral and documentary, was introduced by the respective parties upon the issues so joined, as per Reporter's Transcript thereof, pages 1-137, both inclusive, which is herewith transmitted. Thereupon, said issues were ordered submitted to the undersigned for decision upon briefs to be submitted by counsel for the respective parties, which said briefs were so submitted, and after full consideration thereof and of the record before the Court, the undersigned Referee in Bankruptcy made and filed herein the following Findings of Fact:

I.

That at and before the filing of the petition for adjudication in bankruptcy herein, the above-named Bankrupt was and is justly and truly indebted to said Claimants in the respective sums of \$34,147.55 and \$7,871.17 for the considerations set forth, respectively, in said Proofs of Claim.

II.

That said Claimants were at said time and at all times from and after the first day of October, 1952 each the owners of one-third ($\frac{1}{3}$) of the issued and outstanding capital stock of the above-named bankrupt corporation, and were, respectively, the President and Secretary-Treasurer and Directors of said corporation.

III.

That to and including the 30th day of September, 1952, the business of "Leonard Plumbing and Heating Supply Co." was a co-partnership composed of said Claimants and one B. T. Leonard and that the same type of business was conducted by said partnership at the same location where and which said bankrupt corporation conducted its business.

IV.

That the Promissory Notes upon which said Proofs of Claim are predicated were issued by said corporation in lieu of all of the capital investment of said Claimants in said partnership, saving and excepting the sum of \$2,000.00 each; and that, pursuant to a Permit therefor issued by the Commis-

sioner of Corporations of the State of California under date of January 20, 1953, all of the assets of the aforesaid co-partnership of Leonard Plumbing and Heating Supply Co., were acquired by the above-named Bankrupt in consideration of the issuance by said bankrupt corporation of 200 shares of its capital stock each to said Claimants and to said B. T. Leonard, subject to liabilities of said co-partnership in the aggregate sum of \$162,162.22, together with such additional liabilities as may have been incurred after September 30, 1952 by said partnership in the ordinary course of business to the date of the transfer of its assets to said corporation, and that the net worth of the assets so transferred by said co-partnership to said Bankrupt at the time of such transfer was no less than the stated value, to-wit: \$6,000.00 of the shares of stock so issued as part of the consideration therefor.

V.

That said bankrupt corporation was organized by said Claimants and by said B. T. Leonard and said transfer of the assets of said co-partnership to said bankrupt corporation was made in good faith and for a fair and valuable consideration, and that at the time of said transfer of the assets of said co-partnership, subject to its liabilities as aforesaid, neither said co-partnership nor said corporation were insolvent.

VI.

That the paid-in stated capital of said bankrupt corporation was at the time of its acquisition of the

assets of said partnership, subject to its liabilities as aforesaid, adequate, under all of the facts and circumstances attending same for the continued operation of the plumbing supply business theretofore operated by said co-partnership and thereafter operated by said bankrupt corporation.

VII.

That although Claimants by virtue of their ownership of the said aggregate of 66 $\frac{2}{3}$ % of the issued and outstanding capital stock of the bankrupt corporation and their appointment and activities as constituting a majority of the Board of Directors of said bankrupt corporation controlled and dominated the said corporation and its affairs, they did not mismanage the said business or any part thereof, nor did said Claimants, or either of them, by any of their acts, separately or jointly, practice upon said bankrupt corporation, its other stockholder and/or any of its creditors any fraud or deception, whatever, nor did they act in connection with said corporation or the issuance to them of the Promissory Notes upon which their said Proofs of Claim on file herein are predicated to the detriment of said bankrupt corporation, its other stockholder or any of its creditors for their own personal or private benefit, or otherwise, or at all.

VIII.

That at the time of the commencement of the above-entitled proceedings, said bankrupt corporation was not indebted to any creditors whose obliga-

tions were incurred by the said pre-existing co-partnership known as "Leonard Plumbing and Heating Supply Co.", saving and excepting to the extent that the Promissory Notes upon which the said Proofs of Claim herein filed by Claimants are predicated represented, as aforesaid, a part of the capital of the said co-partnership as of the closing of business on the 30th day of September, 1952.

IX.

That it is not true, as alleged in said Trustee's Objections, that the incorporation of the bankrupt and the issuance to Claimants of the Promissory Notes in question, or either of them, was a part of any scheme or plan to place Claimants, as such co-partners, in the same class as the unsecured creditors of said partnership.

X.

That the sum of \$1,250.00 was and is a reasonable sum to be allowed to the attorneys for Claimant, J. A. Fazio, in connection with the Alameda County Superior Court action No. 258062.

XI.

That the Promissory Notes upon which the said Proofs of Claim herein filed by Claimants are predicated were not, nor were any of them, intended to be by the parties thereto, nor were they, promises to pay the respective amounts thereof from any specific or any uncertain fund.

Wherefrom, the undersigned concluded:

I.

That in the procurement of the Promissory Notes upon which the Proofs of Claim herein filed by Claimants are predicated, said Claimants acted in all respects in good faith and took no unfair advantage of either the bankrupt corporation, its other stockholder, or any of its then existing or subsequent creditors, and that said Claimants and each of them are therefore entitled to participation on a pro-rata basis in the assets of the estate of the above-named bankrupt with all other general and wholly unsecured creditors on file, approved and allowed herein.

Opinion

Upon the basis of the record as aforesaid, the Findings of Fact, and Conclusions of Law, the undersigned Referee in Bankruptcy felt that no legal or equitable showing had been made by the Trustee sufficient, after weighing the mass of conflicting evidence upon the issues so joined, to sustain his said Objections and to justify the subordination of the claims of said J. A. Fazio and L. C. Ambrose to those of the other general and wholly unsecured creditors whose claims are on file, approved and allowed herein.

The undersigned Referee in Bankruptcy thereupon, on the 28th day of August, 1956, made and entered herein that certain "Order Overruling Trustee's Objections to Proofs of Claim of J. A. Fazio and L. C. Ambrose," to which said Trustee timely filed his said Petition for Review, and to which said Petition for Review is properly an-

nexed, as required by Section 39(c) of the Bankruptcy Act a full, true and correct copy of the said Order of the undersigned above referred to.

Comments on Petition for Review

Contrary to the observations of the Trustee in his Petition for Review, the evidence that the claims of J. A. Fazio and L. C. Ambrose were to be "liquidated out of the profits" was not only not uncontradicted but, in the opinion of the undersigned, was not so limited.

In considering the weight of the evidence as to the alleged inadequacies of the capital of the bankrupt corporation, the undersigned Referee in Bankruptcy took into consideration not only the testimony of the Trustee's expert witnesses (Messrs. Curran, Heinbucher, and Logan), but also the testimony of the Claimants' expert witness (Mr. LaBorde), and resolved that conflict in favor of the Claimants.

Also contrary to the observations of the Trustee in his Petition for Review, the evidence adduced at the hearing was not uncontradicted but was, in fact, highly controversial on the subject of the purpose of the incorporation of the pre-existing partnership and there was, in the opinion of the undersigned, no substantial evidence to justify a finding that the organization of the bankrupt corporation was for "the sole purpose" of the co-partnership, in setting up the corporation to take over the assets and liabilities of the co-partnership, was to provide a means by which the Claimants, J. A. Fazio and L. C. Am-

brose, were to share pro-rata in the assets of the corporation in the event of liquidation or bankruptcy.

The evidence on the subject of the alleged inadequacies of the paid-in stated capital of the bankrupt corporation was likewise, contrary to the observations of the Trustee in his Petition for Review, not uncontradicted but was highly controversial and carefully considered and weighed by the undersigned. Lastly, contrary to the other observations made by said Trustee in his said Petition for Review, all of the findings of fact made by the undersigned Referee in Bankruptcy in the premises were based upon, as the transcript will show, conflicting evidence.

Dated at Oakland in said District this 6th day of February, 1957.

Respectfully submitted,

/s/ BERNARD J. ABROTT,
Referee in Bankruptcy.

Original Documents Transmitted
With This Certificate

1. Proof of Claim filed herein by J. A. Fazio in the sum of \$34,147.55.
2. Proof of Claim filed herein by L. C. Ambrose in the sum of \$7,871.17.
3. Trustee's Objections (filed herein on December 20, 1956) to Proof of Claim filed by J. A. Fazio.
4. Trustee's Objections (filed herein on December 30, 1956) to Proof of Claim filed by L. C. Ambrose.

5. (Trustee's) Opening Memorandum of Points and Authorities.

6. Claimants' Reply Memorandum of Points and Authorities.

7. Trustee's Closing Memorandum of Points and Authorities.

8. Letter dated June 13, 1956 from attorneys for J. A. Fazio to Referee commenting on Trustee's Closing Memorandum of Points and Authorities.

9. Order Overruling Trustee's Objections to Proof of Claim of J. A. Fazio and L. C. Ambrose (filed August 28, 1956).

10. Order Extending Time to File Petition for Review dated September 4, 1956.

11. (Trustee's) Petition for Review.

12. Reporter's Transcript (Index Pgs. I and II), pp. 1-137, both inclusive.

13. Trustee's Exhibits Nos. 1-5, both inclusive.

14. Claimants' Exhibits Nos. 1-5, both inclusive.

[Endorsed]: Filed Feb. 7, 1957.

[Title of District Court and Cause.]

PROOF OF CLAIM AND LETTER
OF ATTORNEY

State of California,
City and County of San Francisco—ss.

J. A. Fazio, of Oakland in the County of Alameda, and State of California, personally known to me, being by me duly sworn, deposes and says:

* * * * *

That Leonard Plumbing & Heating Supply, Inc., the above named bankrupt, by or against whom a petition for adjudication of bankruptcy or for an arrangement or for reorganization has been filed, was at and before the filing of such petition and still is justly and truly indebted or liable to claimant in the sum of \$34,147.55.

That the consideration of said debt or liability is as follows:

Balance owing on Promissory Note, was for value, made, executed and delivered by Bankrupt to Claimant under date of October 1, 1952 in the original sum of \$41,169.61, original of which said Promissory Note is attached hereto, marked Exhibit "A," and hereby expressly referred to and made part hereof. Plus reasonable attorney's fees incurred in Alameda County Superior Court action No. 258062 in the sum of \$1,250.00.

That the items of said debt became due upon the dates as respectively set forth upon said Promissory Note marked "Exhibit A."

(b) That the instrument upon which said debt or liability is founded is attached hereto and marked Exhibit "A".

That no part of said debt or liability has been paid; that there are no set-offs or counterclaims to the same; that no note or other negotiable instrument has been received for said account or any part thereof (except the note... hereto attached as Exhibit "B") and that no judgment has been rendered thereon (except as hereinabove set forth).

That claimant does not hold, and has not, nor has any person, by his or its order, or to deponent's knowledge or belief, for claimant's use, had or received, any security or securities for said debt or liability except as disclosed herein.

This claim is free from usury as defined by the laws of the State where the debt was contracted.

Claimant also herewith authorizes Arthur P. Shapro and August B. Rothschild, or any one of them, with full power of substitution, to attend all meetings of creditors of the bankrupt or debtor aforesaid and all adjournments thereof at the places and times appointed by the court, and for claimant and in his or its name to vote for or against any proposal or resolution that may be then submitted under the Acts of Congress relating to bankruptcy, to vote for a trustee or trustees of the estate of said bankrupt or debtor, and for a committee of creditors, to accept any arrangement or wage earner's plan proposed by said bankrupt or debtor, and to receive payment of dividends and payment or delivery of money or of other consideration due claimant under such arrangement, reorganization, or wage earner's plan and for any other purpose in claimant's interest whatsoever, and with like powers to attend and vote at any other meeting or meetings of creditors or sitting or sittings of the court which may be held therein for any of the purposes aforesaid, and to receive or waive any of the notices required by section 58 of the Bankruptcy Act, and claimant does hereby revoke all letters of attorney heretofore given by claimant in this matter.

In witness whereof, and with the intention of having one individual signature suffice for the above deposition and this letter of attorney, said claimant has hereunto subscribed his name, or, if a corporation, has caused such subscription to be made by said officer or agent as its corporate act, or, if a partnership, has caused such subscription to be made by said member thereof on its behalf, or, if an individual or partnership acting through an agent or attorney, has caused such subscription to be made by such attorney or agent as the act of said principal, this 16th day of March, 1955.

/s/ J. A. FAZIO

Subscribed, sworn to and acknowledged before me this 16th day of March, 1955.

[Seal] /s/ FRANCES R. WIENER,

Notary Public in and for the City and County of San Francisco, State of California. My Commission Expires Feb. 17, 1958.

EXHIBIT "A"

\$41,169.61—Oakland, California, October 1, 1952

On Demand for value received, I (or we, jointly or severally) promise to pay to the order of J. A. Fazio at Oakland, California, the sum of Forty-one thousand, one hundred sixty-nine and 61/100 Dollars in lawful money of the United States of America, with interest from—No interest—at the rate of per cent per annum until paid, payable on and thereafter, in like lawful money, and if not paid as it becomes due,

to be added to the principal and become a part thereof and to bear interest at the same rate.

In the event of commencement of suit to enforce payment of this note, the undersigned jointly and severally agree to pay such additional sum as attorney's fees as the Court may adjudge reasonable.

[Seal] LEONARD PLUMBING & HEATING SUPPLY, INC.

/s/ J. A. FAZIO,

/s/ B. T. LEONARD,

/s/ LAWRENCE C. AMBROSE.

[Endorsed]: Filed March 18, 1955.

[Title of District Court and Cause.]

PROOF OF CLAIM IN BANKRUPTCY

State of California,
County of Alameda—ss.

Lawrence C. Ambrose, of No. 130 Crestview Street, Orinda, County of Contra Costa, State of California, being duly sworn, deposes and says:

* * * * *

2. That the above-named bankrupt (or debtor) was at and before the filing by (or against) him of the petition herein (for adjudication of bankruptcy), and still is, justly and truly indebted (or liable) to said deponent (or copartnership or corporation), in the sum of Seven thousand eight hundred seventy-one dollars and 17/100 (\$7,871.17).

3. That the consideration of said debt (or liability) is as follows: Money loaned to company.

4. That no part of said debt (or liability) has been paid except; none.

5. That there are no set-offs or counterclaims to said debt (or liability), except; none.

6. That deponent (or said copartnership or said corporation) does not hold, and has not, nor has any person by his (or its) order, or to deponent's knowledge or belief, for his (or its) use, had or received, any security or securities for said debt (or liability), except; none.

* * * * *

9. This claim is filed as an Unsecured Claim.

/s/ LAWRENCE C. AMBROSE

Subscribed and sworn to before me this 28th day of March, 1955.

[Seal] /s/ MARGARET ROBINSON,
My Commission Expires Aug.
12, 1957.

[Endorsed]: Filed March 28, 1955.

[Title of District Court and Cause.]

TRUSTEE'S OBJECTIONS TO PROOF OF
CLAIM FILED BY J. A. FAZIO

Now comes John Costello, the duly appointed, qualified and acting trustee of the estate of the above named bankrupt, and objects to the allowance by this Court of that certain proof of claim heretofore filed herein on the 18th day of March, 1955, by J. A. Fazio, being Referee's Claim No. 142, on the following grounds:

That said bankrupt corporation, or the estate of said bankrupt corporation, was not, at or before the filing of the voluntary petition for adjudication herein, and is not now, justly or truly indebted to said claimant in the sum of \$34,147.55, as set forth in said alleged claim filed herein by said claimant, or in any other sum or at all, and the trustee calls for proof on the part of said claimant to substantiate said claim pursuant to these objections.

As and for a second, separate and distinct objection to the allowance of said claim, said trustee alleges that said claimant J. A. Fazio has been a stockholder of the above named bankrupt corporation since it was organized on or about the 30th day of September, 1952, and still continues to be a stockholder thereof, owning thirty-three and one-third per cent ($33\frac{1}{3}\%$) of the outstanding capital stock of said bankrupt corporation; that at all times since said bankrupt corporation was incorporated said claimant was and now is the duly elected and acting Director and President of said corporation.

That prior to the time said bankrupt was incorporated, Leonard Plumbing & Heating Supply, Inc., was a copartnership composed of B. T. Leonard, Lawrence C. Ambrose and J. A. Fazio, claimant herein, under the firm name of "Leonard Plumbing & Heating Supply Co."; that the same type of business was conducted by said copartnership at the same location where said bankrupt corporation conducted its business.

That the amount set forth in the claim filed by the said J. A. Fazio, claimant herein, represented

a portion of the capital investment in said copartnership; that at the time said bankrupt was incorporated all of the capital investment, including that of the said J. A. Fazio, was converted from partnership capital account to an account entitled "Loans from Copartners"; that, in truth and in fact, this transaction was a scheme and plan to place said copartners in the same class as the unsecured creditors of said copartnership and the bankrupt corporation thereafter organized to take over the assets and liabilities of said copartnership; that if said claimant is permitted to share in the assets of said bankrupt now in the hands of the trustee, in the same parity with general unsecured creditors, he will receive a portion of the capital invested which should be used to satisfy the claims of creditors before any capital investment can be returned to the owners and stockholders of said bankrupt.

As and for a third, separate and distinct objection to the allowance of said claim, said trustee denies that said claimant is entitled to the sum of \$1,250.00, or any other sum or at all, for reasonable attorneys' fees incurred in Alameda County Superior Court Action No. 258062, or in any other court action.

That for the reasons above set forth, the claim of J. A. Fazio should be subordinated to the claim of general unsecured creditors of said bankrupt corporation.

Wherefore, John Costello, as trustee of said

Leonard Plumbing & Heating Supply, Inc., a California corporation, bankrupt, prays:

(1) That due notice be given to J. A. Fazio, claimant herein, of the hearing of said objections and that upon said hearing claimant be directed to attend.

(2) That after a hearing on said objections, an order be made and entered sustaining said objections and disallowing said claim filed by the said J. A. Fazio.

(3) That said claim of J. A. Fazio be decreed to be inferior in right to the interests of the general unsecured creditors of Leonard Plumbing & Heating Supply, Inc., a corporation, bankrupt, in any distribution of the assets of said bankrupt in said bankruptcy proceedings.

(4) For such other and further relief as to the Court may seem just and proper in the premises.

/s/ JOHN COSTELLO,

Trustee.

FRANCIS P. WALSH &
HENRY GROSS,
JAMES M. CONNERS,
STUART R. DOLE,

/s/ By FRANCIS P. WALSH,
Attorneys for Trustee.

Duly Verified.

[Endorsed] : Filed Dec. 20, 1955.

[Title of District Court and Cause.]

TRUSTEE'S OBJECTIONS TO PROOF OF
CLAIM FILED BY LAWRENCE C. AM-
BROSE

Now comes John Costello, the duly appointed, qualified and acting trustee of the estate of the above named bankrupt, and objects to the allowance by this Court of that certain proof of claim heretofore filed herein on the 28th day of March, 1955, by Lawrence C. Ambrose, being Referee's Claim No. 144, on the following grounds:

That said bankrupt corporation, or the estate of said bankrupt corporation, was not, at or before the filing of the voluntary petition for adjudication herein, and is not now, justly or truly indebted to said claimant in the sum of \$7,871.17, as set forth in the alleged claim filed herein by said claimant, or in any other sum, or at all, and the trustee calls for proof on the part of said claimant to substantiate said claim pursuant to these objections.

As and for a second, separate and distinct objection to the allowance of said claim, said trustee alleges that said claim does not show, nor can it be ascertained therefrom, how, or in what manner, the amount set forth therein was arrived at.

As and for a third, separate and distinct objection to the allowance of said claim, said trustee alleges that said claim has not been executed in accordance with the provisions of the Bankruptcy Act.

As and for a fourth, separate and distinct ob-

jection to the allowance of said claim, said trustee alleges as follows:

That said claimant Lawrence C. Ambrose has been a stockholder of the above named bankrupt corporation since it was organized on or about the 30th day of September, 1952, and still continues to be a stockholder thereof, owning thirty-three and one-third per cent ($33\frac{1}{3}\%$) of the outstanding capital stock of said bankrupt corporation; that at all times since said bankrupt corporation was incorporated said claimant was and now is the duly elected and acting Director and Secretary of said corporation.

That prior to the time said bankrupt was incorporated, Leonard Plumbing & Heating Supply, Inc., was a copartnership composed of J. A. Fazio, B. T. Leonard and Lawrence C. Ambrose, claimant herein, doing business under the firm name of "Leonard Plumbing & Heating Supply Co."; that the same type of business was conducted by said copartnership at the same location where said bankrupt corporation conducted its business.

That the amount set forth in the claim filed by the said Lawrence C. Ambrose, claimant herein, represented a portion of the capital investment in said copartnership; that at the time said bankrupt was incorporated all of the capital investment, including that of the said Lawrence C. Ambrose, was converted from partnership capital account to an account entitled "loans from copartners"; that, in truth and in fact, this transaction was a scheme and plan to place said copartners in the same class

as the unsecured creditors of said copartnership and the bankrupt corporation thereafter organized to take over the assets and liabilities of said copartnership; that if said claimant is permitted to share in the assets of said bankrupt now in the hands of the trustee, in the same parity with general unsecured creditors, he will receive a portion of the capital invested which should be used to satisfy the claims of creditors before any capital investment can be returned to the owners and stockholders of said bankrupt.

That for the reasons above set forth, the claim of Lawrence C. Ambrose should be subordinated to the claims of general unsecured creditors of said bankrupt corporation.

Wherefore, John Costello, as trustee of said Leonard Plumbing & Heating Supply, Inc., a California corporation, bankrupt, prays:

(1) That due notice be given to Lawrence C. Ambrose, claimant herein, of the hearing of said objections and that upon said hearing claimant be directed to attend.

(2) That after a hearing on said objections, an order be made and entered sustaining said objections and disallowing said claim filed by the said Lawrence C. Ambrose.

(3) That said claim of Lawrence C. Ambrose be decreed to be inferior in right to the interests of the general unsecured creditors of Leonard Plumbing & Heating Supply, Inc., a corporation, bank-

rupt, in any distribution of the assets of said bankrupt in said bankruptcy proceedings.

(4) For such other and further relief as to the Court may seem just and proper in the premises.

/s/ JOHN COSTELLO,

Trustee.

FRANCIS P. WALSH &

HENRY GROSS,

JAMES M. CONNERS,

STUART R. DOLE,

/s/ By FRANCIS P. WALSH,

Attorneys for Trustee.

Duly Verified.

[Endorsed]: Filed Dec. 20, 1955.

[Title of District Court and Cause.]

ORDER OVERRULING TRUSTEE'S OBJECTIONS TO PROOFS OF CLAIM OF J. A. FAZIO AND L. C. AMBROSE

The duly verified Objections heretofore filed herein by John Costello, Trustee of the above estate, to the Proofs of Claim heretofore filed herein by J. A. Fazio and L. C. Ambrose in the respective sums of \$34,147.55 and \$7,871.17, having regularly come on for hearing before the above-entitled Court on the 17th day of January, 1956, on the 25th day of January, 1956, and on the 13th day of February, 1956, said Claimants being represented by, respectively, Messrs. Shapro & Rothschild (Arthur

P. Shapro, Esq., appearing), and Hon Chew, Esq., their attorneys, and said Trustee being represented by Messrs. Francis P. Walsh, Esq., and Stuart R. Dole, Esq., his attorneys, and evidence, both oral and documentary, having been adduced by the respective parties upon the issues so joined, and the matter having been duly argued by counsel for the respective parties and submitted to the Court for decision, and the Court being fully advised in the premises Finds:

I.

That at and before the filing of the petition for adjudication in bankruptcy herein, the above-named Bankrupt was and is justly and truly indebted to said Claimants in the respective sums of \$34,147.55 and \$7,871.17 for the considerations set forth, respectively, in said Proofs of Claim.

II.

That said Claimants were at said time and at all times from and after the first day of October, 1952 each the owners of one-third ($\frac{1}{3}$) of the issued and outstanding capital stock of the above-named bankrupt corporation, and were, respectively, the President and Secretary-Treasurer and Directors of said corporation.

III.

That to and including the 30th day of September, 1952, the business of "Leonard Plumbing and Heating Supply Co." was a copartnership composed of said Claimants and one B. T. Leonard and that the same type of business was conducted by said

partnership at the same location where and which said bankrupt corporation conducted its business.

IV.

That the Promissory Notes upon which said Proofs of Claim are predicated were issued by said corporation in lieu of all of the capital investment of said Claimants in said partnership, saving and excepting the sum of \$2,000.00 each; and that, pursuant to a Permit therefor issued by the Commissioner of Corporations of the State of California under date of January 20, 1953, all of the assets of the aforesaid co-partnership of Leonard Plumbing and Heating Supply Co., were acquired by the above-named Bankrupt in consideration of the issuance by said bankrupt corporation of 200 shares of its capital stock each to said Claimants and to said B. T. Leonard, subject to liabilities of said co-partnership in the aggregate sum of \$162,162.22, together with such additional liabilities as may have been incurred after September 30, 1952 by said partnership in the ordinary course of business to the date of the transfer of its assets to said corporation, and that the net worth of the assets so transferred by said co-partnership to said Bankrupt at the time of such transfer was no less than the stated value, to-wit: \$6,000.00 of the shares of stock so issued as part of the consideration therefor.

V.

That said bankrupt corporation was organized by said Claimants and by said B. T. Leonard and

said transfer of the assets of said co-partnership to said bankrupt corporation was made in good faith and for a fair and valuable consideration, and that at the time of said transfer of the assets of said co-partnership, subject to its liabilities as aforesaid, neither said co-partnership nor said corporation were insolvent.

VI.

That the paid-in stated capital of said bankrupt corporation was at the time of its acquisition of the assets of said partnership, subject to its liabilities as aforesaid, adequate, under all of the facts and circumstances attending same for the continued operation of the plumbing supply business theretofore operated by said co-partnership and thereafter operated by said bankrupt corporation.

VII.

That although Claimants by virtue of their ownership of the said aggregate of $66\frac{2}{3}\%$ of the issued and outstanding capital stock of the bankrupt corporation and their appointment and activities as constituting a majority of the Board of Directors of said bankrupt corporation controlled and dominated the said corporation and its affairs, they did not mismanage the said business or any part thereof, nor did said Claimants, or either of the, by any of their acts, separately or jointly, practice upon said bankrupt corporation, its other stockholder and/or any of its creditors any fraud or deception whatever, nor did they act in connection with said corporation or the issuance to them of the Promis-

sory Notes upon which their said Proofs of Claim on file herein are predicated to the detriment of said bankrupt corporation, its other stockholder or any of its creditors for their own personal or private benefit, or otherwise, or at all.

VIII.

That at the time of the commencement of the above-entitled proceedings, said bankrupt corporation was not indebted to any creditors whose obligations were incurred by the said pre-existing co-partnership known as "Leonard Plumbing and Heating Supply Co.," saving and excepting to the extent that the Promissory Notes upon which the said Proofs of Claim herein filed by Claimants are predicated represented, as aforesaid, a part of the capital of the said co-partnership as of the closing of business on the 30th day of September, 1952.

IX.

That it is not true, as alleged in said Trustee's Objections, that the incorporation of the bankrupt and the issuance to Claimants of the Promissory Notes in question, or either of the, was a part of any scheme or plan to place Claimants, as such co-partners, in the same class as the unsecured creditors of said partnership.

X.

That the sum of \$1,250.00 was and is a reasonable sum to be allowed to the attorneys for Claimant, J. A. Fazio, in connection with the Alameda County Superior Court action No. 258062.

XI.

That the Promissory Notes upon which the said Proofs of Claim herein filed by Claimants are predicated were not, nor were any of them, intended to be by the parties thereto, nor were they, promises to pay the respective amounts thereof from any specific or any uncertain fund.

Wherefrom, the Court Concludes:

I.

That in the procurement of the Promissory Notes upon which the Proofs of Claim herein filed by Claimants are predicated, said Claimants acted in all respects in good faith and took no unfair advantage of either the bankrupt corporation, its other stockholder, or any of its then existing or subsequent creditors, and that said Claimants and each of them are therefore entitled to participation on a pro-rata basis in the assets of the estate of the above-named bankrupt with all other general and wholly unsecured creditors on file, approved and allowed herein, and good cause appearing therefor,

It Is Hereby Ordered that the said Objections heretofore interposed herein by said John Costello, as Trustee of the estate of the above-named Bankrupt, to the said Proofs of Claim heretofore filed herein by said J. A. Fazio and L. C. Ambrose in the respective sums of \$34,147.55 and \$7,871.17 be and the same are hereby overruled and that said claims, and each of them, be and they are hereby allowed, as filed, as general and wholly unsecured claims

against said estate, for pro-rata participation as such in the assets of said estate.

Dated at Oakland in said District this 28th day of August, 1956.

/s/ BERNARD J. ABROTT,
Referee in Bankruptcy.

[Endorsed]: Filed Aug. 28, 1956.

[Title of District Court and Cause.]

ORDER EXTENDING TIME TO FILE
PETITION FOR REVIEW

Good Cause Appearing Therefor,

It Is Hereby Ordered that John Costello, trustee of the estate of Leonard Plumbing & Heating Supply, Inc., a California corporation, the above named bankrupt, may have to and including the 4th day of October, 1956, within which to file his petition, as such trustee, to review the order of the Hon. Bernard J. Abrott, Referee in Bankruptcy in the above entitled matter, dated the 28th day of August 1956, overruling the trustee's objections to the proofs of claims of J. A. Fazio and L. C. Ambrose.

Dated: September 4th, 1956.

/s/ BERNARD J. ABROTT,
Referee in Bankruptcy.

[Endorsed]: Filed Sept. 4, 1956.

[Title of District Court and Cause.]

PETITION FOR REVIEW

To The Honorable Bernard J. Abrott, Referee in
Bankruptcy of the above-entitled Court, at Oak-
land, California:

The petition of John Costello, the duly appointed, qualified and acting trustee of Leonard Plumbing and Heating Supply, Inc., a California corporation, the above-named Bankrupt, respectfully represents:

I.

That your petitioner, as such trustee, is aggrieved by the order of the Honorable Bernard J. Abrott herein dated August 28, 1956, a copy of which order is annexed hereto, marked Exhibit "A" and made a part hereof.

II.

That said order holds that the unsecured claims of J. A. Fazio and L. C. Ambrose in the respective sums of \$34,147.55 and \$7,871.17 objected to herein by your petitioner, as such trustee of the above-named Bankrupt estate, be allowed in full as filed and permits said Claimants to participate on a pro-rata share basis in the assets of the estate of said Bankrupt with the allowed claims of all other general and wholly unsecured creditors; that it further orders that the objections heretofore interposed by your petitioner, as such trustee of said bankrupt estate, be overruled.

Petitioner contends that the claims of J. A. Fazio

and L. C. Ambrose, if allowed at all, should be subordinated to those of the other unsecured creditors upon the following grounds:

(a) The so-called "deep rock" doctrine established by the U. S. Supreme Court requires that the claims of controlling shareholders for purported loans to themselves will be subordinated to those of general creditors where the corporation has been inadequately capitalized; to do otherwise would be unfair and inequitable to those creditors.

(b) Admitted capital contributions cannot, as a matter of law, be later converted into debt obligations by the simple expedient of taking back promissory notes for such capital advances so that such contributors can participate with general unsecured creditors when the business later goes into bankruptcy.

(c) A conditional obligation to pay a debt out of an uncertain fund does not accrue until the condition is performed. Accordingly, when the testimony is undisputed that the claims of J. A. Fazio and L. C. Ambrose were to be "liquidated out of profits" and when such profits never arise, as was the case here, the claim is not provable in bankruptcy.

III.

That the Referee erred in said order in that the first finding of fact therein finds: "That at and before the filing of the petition for adjudication in bankruptcy herein, the above-named Bankrupt was and is justly and truly indebted to said Claimants in the respective sums of \$34,147.55 and \$7,871.17

for the considerations set forth, respectively, in said Proofs of "Claim."

Since the uncontradicted evidence conclusively shows that the claims of J. A. Fazio and L. C. Ambrose were to be "liquidated out of profits," and since such profits were never earned by the bankrupt corporation, the estate of said Bankrupt is not justly and truly indebted to said Claimants in the respective sums of \$34,147.55 and \$7,871.17.

IV.

The Referee erred in said order in that the fourth finding of fact therein holds as follows: "That the Promissory Notes upon which said Proofs of Claim are predicated were issued by said corporation in lieu of all of the capital investment of said Claimants in said partnership."

Since the consideration for said notes is capital investment, the case falls directly within the doctrines set forth in *Pepper v. Litton* and *Arnold v. Phillips* cited in trustee's opening and closing memorandums. As capital investment, such contributions cannot be turned into debts by afterward issuing notes so that the contributors can participate with general creditors. (See particularly the extract from *Arnold v. Phillips*) Shareholders cannot, by the very nature of this type of investment, share in their capital contribution with outside creditors.

The Referee further erred in the fourth finding which holds that: "* * * The net worth of the assets so transferred by said co-partners to said Bankrupt at the time of such transfer was no less than

the stated value, to-wit, \$6,000.00 of the shares of stock so issued as part of the consideration therefor.”

By the opening balance sheet of Leonard Plumbing and Heating Supply, Inc., its current liabilities were shown to exceed current assets by the sum of \$1,370.35. Furthermore, the opinion of the trustee's expert witnesses support this contention.

V.

The Referee erred in said order in that the fifth finding of fact holds as follows: “That said bankrupt corporation was organized by said Claimants and by said B. T. Leonard and said transfer of the assets of said co-partnership to said bankrupt corporation was made in good faith and for a fair and valuable consideration, and that at the time of said transfer of the assets of said co-partnership, subject to its liabilities as aforesaid, neither said co-partnership nor said corporation were insolvent.”

The uncontradicted evidence adduced at the hearing showed conclusively that the sole purpose of the co-partnership in setting up the corporation to take over the assets and liabilities of the co-partnership was to provide a means by which the Claimants J. A. Fazio and L. C. Ambrose were to share pro-rata in the assets of the corporation in the event of liquidation or bankruptcy.

VI.

The Referee erred in said order in that the sixth finding of fact therein holds: “That the paid-in stated capital of said bankrupt corporation was at

the time of its acquisition of the assets of said partnership, subject to its liabilities as aforesaid, adequate, under all of the facts and circumstances attending same for the continued operation of the plumbing supply business theretofore operated by said co-partnership and thereafter operated by said bankrupt corporation.”

The uncontradicted evidence adduced at the hearing showed conclusively that paid-in stated capital of the bankrupt corporation was at all times inadequate.

VII.

The Referee erred in said order in that the seventh finding of fact therein holds: “That although Claimants by virtue of their ownership of the said aggregate of $66\frac{2}{3}\%$ of the issued and outstanding capital stock of the bankrupt corporation and their appointment and activities as constituting a majority of the Board of Directors of said bankrupt corporation controlled and dominated the said corporation and its affairs, they did not mismanage the said business or any part thereof, nor did said Claimants, or either of them, by any of their acts, separately or jointly, practice upon said bankrupt corporation, its other stockholder and/or any of its creditors any fraud or deception whatever, nor did they act in connection with said corporation or the issuance to them of the Promissory Notes upon which their said Proofs of Claim on file herein are predicated to the detriment of said bankrupt corporation, its other stockholder or any of

its creditors for their own personal or private benefit, or otherwise, or at all.”

The uncontradicted evidence adduced at the hearing conclusively shows that at the time said Bankrupt was incorporated all capital investment, including that of Claimants J. A. Fazio and L. C. Ambrose, were converted from the partnership account to an account entitled “Loans from Co-Partnership” and this action was a scheme and device to place said co-partners in the same class as unsecured creditors of said co-partnership and the bankrupt corporation thereafter organized to take over the assets and liabilities of said co-partnership; that said Claimants so dominated and controlled said corporation and its affairs to permit said scheme and plan to be carried out.

VIII.

That the Referee erred in said order in that the eighth finding of fact therein holds: “That it is not true, as alleged in said Trustee’s Objections, that the incorporation of the bankrupt and the issuance to Claimants of the Promissory Notes in question, or either of them, was a part of any scheme or plan to place Claimants, as such co-partners, in the same class as the “unsecured creditors of said partnership.”

The uncontradicted evidence adduced at the hearing shows conclusively that the incorporation of the Bankrupt and the issuance to Claimants of the promissory notes in question was a part of the scheme and plan to place Claimants in the same

class as the unsecured creditors of the co-partnership.

IX.

The Referee erred in said order in that the ninth finding of fact therein holds: "That the sum of \$1,250.00 was and is a reasonable sum to be allowed to the attorneys for Claimant, J. A. Fazio, in connection with the Alameda County Superior Court action No. 258062."

The record is absolutely barren of any evidence to support this finding that the sum of \$1,250.00 was and is a reasonable sum to be allowed to the attorneys for Claimants J. A. Fazio and L. C. Ambrose in connection with Alameda County Superior Court action No. 258062, or to show that this estate in bankruptcy is in any way or at all obligated to pay attorneys' fees in said action.

X.

The Referee erred in said order in that the eleventh finding of fact therein holds: "That the Promissory Notes upon which the said Proofs of Claim herein filed by Claimants are predicated were not, nor were any of them, intended to be by the parties thereto, nor were they, promises to pay the respective amounts thereof from any specific or any uncertain fund."

The uncontradicted testimony of the Certified Public Accountant who was called as a witness on behalf of the Claimants shows conclusively that the claims of J. A. Fazio and L. C. Ambrose were to be "liquidated out of the profits." Since such profits

never did arise, the claims could not be approved, allowed and ordered paid by the Referee.

XI.

The Referee erred in the conclusion of law which holds as follows: "That in the procurement of the Promissory Notes upon which the Proofs of Claim herein filed by Claimants are predicated, said Claimants acted in all respects in good faith and took no unfair advantage of either the bankrupt corporation, its other stockholder, or any of its then existing or subsequent creditors, and that said Claimants and each of them are therefore entitled to participation on a pro-rata basis in the assets of the estate of the above-named Bankrupt with all other general and wholly unsecured creditors on file, approved and allowed herein, and good cause appearing therefor."

XII.

The Referee erred in making the following order: "It Is Hereby Ordered that the said Objections heretofore interposed herein by said John Costello, as Trustee of the estate of the above-named Bankrupt, to the said Proofs of Claim heretofore filed herein by said J. A. Fazio and L. C. Ambrose in the respective sums of \$34,147.55 and \$7,871.17 be and the same are hereby overruled and that said claims, and each of them, be and they are hereby allowed, as filed, as general and wholly unsecured claims against said estate, for **pro-rata participation as** such in the assets of said estate."

Wherefore, your petitioner prays that said order

be reviewed by the Judge of the U. S. District Court having jurisdiction in the above-entitled bankruptcy proceedings in accordance with the provisions of the Bankruptcy Act; that said order be reversed; that the trustee's objections to the claim of J. A. Fazio in the sum of \$34,147.55 and the claim of L. C. Ambrose in the sum of \$7,871.17 be sustained and that said claims of J. A. Fazio and L. C. Ambrose be decreed to be inferior in right to the interests of the general unsecured creditors of Leonard Plumbing and Heating Supply, Inc., in any distribution of the assets of said Bankrupt in said proceedings.

/s/ JOHN COSTELLO,

Petitioner.

FRANCIS P. WALSH,

HENRY GROSS,

JAMES M. CONNERS and

STUART R. DOLE,

/s/ By FRANCIS P. WALSH,

Attorneys for Petitioner.

[Note: Exhibit "A"—Order Overruling Trustee's Objections to Proofs of Claim of J. A. Fazio and L. C. Ambrose is set out at pages 24-30 of this printed record.]

Duly Verified.

Certificate of Service by Mail Attached.

[Endorsed]: Filed Sept. 25, 1956.

In The United States District Court, Northern
District of California, Southern Division

No. 43763—In Bankruptcy

In the Matter of

LEONARD PLUMBING & HEATING SUPPLY,
INC., a California corporation, Bankrupt.

ORDER AFFIRMING REFEREE'S ORDER

There is substantial evidence in the record to sustain the findings of the Referee. His order overruling the Trustee's objections to the proofs of the claims of J. A. Fazio and L. C. Ambrose is therefore affirmed.

Dated: April 11, 1957.

/s/ LOUIS E. GOODMAN,
United States District Judge.

[Endorsed]: Filed April 12, 1957.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that John Costello, the duly qualified and acting trustee of the estate of Leonard Plumbing & Heating Supply, Inc., a California corporation, the above named bankrupt, hereby appeals to the United States District Court of Appeals for the Ninth Circuit from the final

order of the Hon. Louis E. Goodman, United States District Judge of the above entitled Court signed on April 11, 1957, and filed on April 12, 1957, affirming the order of the Hon. Bernard J. Abrott, Referee in Bankruptcy, signed and filed on the 28th day of August, 1956, wherein said Referee overruled the trustee's objections to the proofs of claim filed herein by J. A. Fazio and L. C. Ambrose.

Dated at San Francisco this 30th day of April, 1957.

FRANCIS P. WALSH &
HENRY GROSS,

/s/ By FRANCIS P. WALSH,

/s/ JAMES M. CONNERS,

/s/ STUART R. DOLE,

Attorneys for John Costello, Trustee of Leonard Plumbing & Heating Supply, Inc., Bankrupt.

[Endorsed]: Filed May 7, 1957.

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[Title of District Court and Cause.]

CERTIFICATE OF CLERK

I, C. W. Calbreath, Clerk of the United States District Court for the Northern District of California, do hereby certify that the foregoing and accompanying documents, listed below, are the originals filed in this Court in the above-entitled case and that they constitute the record on appeal as designated by the attorneys for the Trustee:

Referee's Certificate on Review of Order overruling.

Proof of Claim of J. A. Fazio.

Proof of Claim of Lawrence Ambrose.

Trustee's Objection of Proof of Claim of J. A. Fazio.

Trustee's Objection of Proof of Claim of L. C. Ambrose.

Opening Memorandum of Points & Authorities—Trustee's.

Claimant's Reply Memorandum of Points & Authorities.

Trustee's Closing Memorandum of Points & Authorities.

Letter of June 13, 1956 to Referee in Bankruptcy.

Order Overruling Trustee's Objections to Proof of Claim of Fazio and Ambrose.

Order Extending Time to File Petition for Review.

Petition for Review.

Transcript of Hearing on Trustee's Objection to Claim of Fazio and Ambrose.

Claimant's Exhibits 1 to 5.

Trustee's Exhibits 1 to 5.

Order Affirming Referee's Order.

Notice of Appeal.

Designation of Contents of Record on Appeal.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court, this 11th day of June, 1957.

[Seal] C. W. CALBREATH,

Clerk.

/s/ WM. J. FLINN,

Deputy Clerk.

In The Southern Division of the United States
District Court, Northern District of California

No. 43763

In The Matter of

LEONARD PLUMBING & HEATING SUPPLY,
INC., a California corporation, Bankrupt.

TRANSCRIPT OF HEARING ON TRUSTEE'S
OBJECTION TO THE CLAIM OF J. A.
FAZIO AND LAURENCE C. AMBROSE

Oakland, California

January 17, 1956, et seq.

Before Honorable Bernard J. Abrott, Referee in
Bankruptcy.

Appearances: Francis P. Walsh, Esq., Stuart
R. Dole, Esq., Attorneys for Objecting Trustee.
Shapro & Rothschild, by Arthur P. Shapro, Esq.,
Attorney for Claimant J. A. Fazio. Frank M.
Crews, Esq., Hon Chew, Esq., Attorneys for Claim-
ant Laurence C. Ambrose.

January 17, 1956—10:00 a.m.

The Referee: Trustee's objection to the claim
of J. A. Fazio.

Mr. Walsh: That's ready, your Honor.

Mr. Dole: That's ready, your Honor.

The Referee: Mr. Walsh and Mr. Dole appear
as attorneys for the objecting trustee; Mr. Shapro
appears for the claimant.

Mr. Shapro: Yes, your Honor. In view of the

contents of the objections as to the proof on the part of the claimant and assuming only the burden of going forward at this time, the creditor will call Mr. Fazio.

Mr. Walsh: Your Honor please, I think that under the law this claim is based upon a balance due on a promissory note. That being the case, I think the burden is on the objecting trustee.

Mr. Shapro: Well, your Honor, I'm only quoting from the objections themselves.

Mr. Walsh: I understand that.

Mr. Shapro: And if counsel for the trustee wants to assume the burden, I have no objection.

The Referee: Very well.

Mr. Dole: Your Honor, there should be a distinction drawn between the claim of J. A. Fazio and the claim of Laurence Ambrose. [1]*

The Referee: We're not proceeding on the claim of Ambrose at the present time.

Mr. Dole: Fine. I suggest, however, and move at this time that so far as the testimony of one or the other applies to the organization as a group that they be combined for that purpose in order to eliminate duplication.

Mr. Shapro: Now, your Honor, I don't quite understand counsel's point. Before I agree to it, I would like to be sure I understand it. If it is the desire of counsel for the trustee to have testimony of any witness other than the witnesses called by either party on behalf of another or in connection

* Page numbers appearing at top of page of original Reporter's Transcript of Record.

with the objection to the claim of Mr. Ambrose, that's something else again but if his request is confined to testimony adduced in connection with the claim or the objection of the claim of Mr. Fazio, of course, I have no objection. In other words, I don't want to have Mr. Fazio bound, your Honor, by any testimony taken in connection with the claim of Mr. Ambrose unless the witnesses are first called by the respective parties in connection with the hearing of the objection to the claim of Mr. Fazio and I understood your Honor to direct that the hearing proceed on the trustee's objection on the claim of Mr. Fazio alone.

The Referee: Correct.

Mr. Dole: Your Honor, what I am suggesting is that [2] actually, the two proceedings be combined for hearing.

The Referee: As long as Mr. Dole has made that suggestion, let the record show that Mr. Crews and Mr. Chew are present in court as counsel for the claimant Ambrose. Mr. Crews and Mr. Chew, Mr. Dole on behalf of the objector has suggested that with reference to the corporation and so forth that rather than to go through the proceedings twice, he would prefer that the examination in the matter of Fazio be considered a part of the matter of Ambrose. You gentlemen have no objection.

Mr. Crews: I have no objection, your Honor, as long as the testimony that's offered will apply where pertinent to the claims of each person involved. It may be combined for the purpose of a hearing.

The Referee: I understand that your statement

was merely to facilitate the hearing rather than to try the matter from the start.

Mr. Dole: Exactly, your Honor.

The Referee: On the same ground.

Mr. Dole: That's right.

The Referee: And that you are primarily concerned with certain questions and answers relative to the partnership and the change into the corporation and so forth, is that right?

Mr. Dole: I am, your Honor.

Mr. Walsh: Your Honor, may I have again the names of [3] the attorneys for Mr. Ambrose?

The Referee: Yes, Mr. Crews of Purchio & Crews.

Mr. Dole: How do you spell that?

Mr. Crews: C-r-e-w-s—Frank M. Crews.

Mr. Dole: And——

The Referee: Mr. Chew, C-h-e-w.

Mr. Chew: C-h-e-w—Hon Chew.

The Referee: And he is of the firm of Purchio & Crews.

Mr. Crews: No, your Honor. He is only associated with our law firm in this particular matter.

The Referee: Based on Mr. Crews' statement, you gentlemen would have no objection.

Mr. Crews: No, your Honor.

The Referee: And Mr. Dole and Mr. Walsh, you may proceed with the objection in the matter of Fazio.

Mr. Dole: I will call Mr. Fazio.

The Referee: Mr. Fazio?

J. A. FAZIO

called as a witness on behalf of the objecting trustee, being first duly sworn by the Referee, testified as follows:

Mr. Dole: Your Honor, for the record, this examination is under the provisions of Section 21(j) of the Bankruptcy Act. [4]

The Referee: Very well. Your name is Mr. J. A. Fazio?

The Witness: J. A. Fazio.

The Referee: And you are the claimant; you are a creditor-claimant in these proceedings.

The Witness: Yes, sir.

Direct Examination

Q. (By Mr. Dole): Mr. Fazio, you are the president of Leonard Plumbing & Heating Supply Company, is that correct? A. Yes, sir.

Q. And you have presented to this court a claim in the amount of \$34,147.55 based upon a promissory note which is attached to the claim in the amount of \$41,169.61, is that correct?

A. Yes, sir.

Q. And what does the difference between those two figures represent, Mr. Fazio?

A. Why, from my stock in the company I donated to Mr. Ambrose.

Q. How much, sir? A. Around \$4,000.00.

Q. You donated your stock, you say?

A. Yes, gave it to Mr. Ambrose as a bonus.

Q. And when you say you donated stock, are you

(Testimony of J. A. Fazio.)

referring to the certificates of stock in the corporation?

A. The amount that I had invested in the Leonard Plumbing Supply.

Q. And did you transfer shares of stock to Mr. Ambrose? A. Mr. Laborde has got that.

The Referee: Wait a minute, I don't want to hear any [5] of this Mr. Laborde. In all probability, Mr. Shapro has Mr. Laborde here for a particular purpose and he may or may not call him. Now, you either answer questions if you can or if you know. You don't have to make any suggestions as to who can answer it. Now, did you give any shares of stock or any stock to Mr. Ambrose?

A. Well, yes, I call it stock.

Q. I see. And how many shares did you transfer to Mr. Ambrose? A. Four Thousand Dollars.

Q. Do you know what the original issue value of the shares was—the value of the shares given on original issue? A. No, I don't remember.

Q. You don't remember. So you don't know how many shares you transferred to him.

A. That's right.

Q. Do you recall the date the transfer was made, sir? A. I don't remember that either.

Q. Now, referring to this note as a whole—Withdraw that, please, Miss Reporter. Does that explain the entire difference between the \$41,169.61, the value of the note and the \$34,147.55 the value of your claim? Does that explain the entire difference between those two figures?

(Testimony of J. A. Fazio.)

Mr. Shapro: I object to the question on the ground it calls for the opinion and conclusion of the witness, your Honor.

The Referee: Do you know whether or not it explains it? [6]

The Witness: The Four Thousand Dollars——

The Referee: Do you know? Just answer the question.

The Witness: Yes, sir.

The Referee: Do you know the reason for the difference in the two amounts?

The Witness: Well, just the amount that I gave to Mr. Ambrose for a bonus.

The Referee: Overruled.

Q. There's no other consideration explaining the difference between these two figures then, is there?

A. No.

Q. Now, referring to the original note, Mr. Fazio, could you tell me the consideration that was given for that note? A. The consideration?

Q. What did you give to the corporation and—yes, to the corporation, in return for the note?

A. Why, material was my stock.

Q. A little while ago on your previous examination, Mr. Walsh asked you what you gave—what consideration you gave for the stock that you received in Leonard Plumbing & Heating Supply Company and you replied that it was the material that you gave to the corporation, is that correct?

A. That's right.

Q. Is that the same material?

(Testimony of J. A. Fazio.)

A. Same material.

Q. It's the same material represented by the stock.

A. Yes, sir.

Q. What did that material consist of that you transferred to the corporation, sir? [7]

A. Fittings of different kinds—plumbing material.

Q. When was that transfer made?

A. When the Leonard Plumbing Supply was started.

Q. Are you referring now to the corporation or the partnership?

A. The partnership.

Q. Do you remember the approximate date? Wasn't that sometime in 1949?

A. I don't remember the exact date.

Q. Do you remember whether it was 1949?

A. The date I can't tell you.

Q. Nineteen forty-nine was the year the partnership was organized.

A. It must have been '49 then.

Q. When you transferred that material, did you have an appraisal made of the material by an independent appraiser?

A. No. Mr. Leonard himself priced it.

Q. Mr. Leonard himself priced it?

A. Yes, sir.

Q. Now, that contribution that you speak of as having been made in 1949 was the entire contribution of the partnership, wasn't it?

A. Yes.

Q. And that's the same thing that you are referring to when you refer to the contribution made to

(Testimony of J. A. Fazio.)

the corporation, isn't it? A. That's right.

Mr. Dole: I have no further questions.

The Referee: Mr. Shapro, do you desire to ask any questions at this time?

Mr. Shapro: Not at this time, your Honor.

The Referee: Thank you, Mr. Fazio. You are temporarily [8] excused. Mr. Dole or Mr. Walsh.

Mr. Dole: I would like to call Mr. Lawrence C. Ambrose, please.

The Referee: Mr. Ambrose.

LAURENCE C. AMBROSE

called as a witness by the objecting trustee, being first duly sworn by the Referee, testified as follows:

The Referee: Your name is Laurence C. Ambrose?

The Witness: Laurence C. Ambrose.

The Referee: And where do you reside, Mr. Ambrose?

The Witness: No. 28 El Galbin, G-a-l-b-i-n.

Mr. Dole: Again, your Honor, I would like the record to show that Mr. Ambrose is being called under the provisions of Section 21(j) of the Bankruptcy Act.

The Referee: So ordered.

Direct Examination

Q. (By Mr. Dole): Mr. Ambrose, are you associated with Leonard Plumbing & Heating Supply Company, Inc. in any way?

A. Secretary-treasurer.

(Testimony of Laurence C. Ambrose.)

Q. You are secretary-treasurer. How long have you occupied that position?

A. Until it closed.

Q. From the inception of the corporation until it closed? A. That's right.

Q. Prior to that, were you associated with the partnership known as Leonard Plumbing & Heating Supply Company? [9] A. That's right.

Q. And in what capacity were you associated?

A. Just a partner.

Q. You say—— A. Just equal partners.

Q. Equal partner. You have submitted a claim in this matter in the sum of \$7,871.17, is that correct?

A. That's right.

Q. What does that sum represent, sir, and what is the consideration?

A. Money loaned to the company or the corporation.

Q. Do you have notes evidencing that money?

A. What?

Q. Do you have notes evidencing that money that was loaned to the corporation?

A. Yes, certainly. Here is one of the checks for \$2,000.00, there's one for \$1,200.00—I couldn't recall the next, but here is what the original note when it was—and this one went back in the corporation, plus \$4,000.00 that was transferred from Fazio to me.

Q. I see. The two checks which you have presented here—— A. As cash.

Q. Check No. 73 and check No. 75——

(Testimony of Laurence C. Ambrose.)

Mr. Dole: Let the record show at this time that Mr. Ambrose has handed me two checks—one dated November 26, 1948, No. 73, drawn on the West Berkeley office of the American Trust Company, Federal Reserve No. 90-1282 over 1211, the check being in the amount of \$1,200.00 payable [10] able to the order of Leonard Plumbing & Heating Supply Company. The check is signed by L. C. Ambrose. The second check is numbered 75, dated December 13, 1948, payable to West Berkeley office of the American Trust Company, with the same federal reserve number. This check is made out to the order of Leonard Plumbing Company. It's in the amount of \$2,000.00, bears the endorsement of L. C. Ambrose.

Mr. Shapro: You said endorsement; you meant signature.

Mr. Dole: Signature. Thank you, Mr. Shapro. Mr. Ambrose has handed me two notes, the first dated September 15, 1952, the note being in the amount of \$4,451.17 to the order of L. C. Ambrose and the note is signed by Leonard Plumbing & Heating Supply Company; it bears the endorsement of J. A. Fazio, B. T. Leonard, Laurence C. Ambrose.

Mr. Shapro: You mean signatures.

Mr. Dole: Signatures. And on the face of the note are the words "replaced by Leonard Plumbing & Heating Supply, Inc. notes." The second note is dated October 1, 1952 in the amount of \$4,051.17, made payable to the order of L. C. Ambrose and the

(Testimony of Laurence C. Ambrose.)

note bears the signature of Leonard Plumbing & Heating Supply, Inc., J. A. Fazio, B. T. Leonard and Laurence C. Ambrose.

Q. Now, Mr. Ambrose, these two checks were not given to the [11] corporation, were they—the sums represented by these two checks?

A. What's that, again?

Q. The sums represented by these two checks were not given to the corporation, were they?

A. No, no, it was given to the business when they first started and it never was taken out of the business—as a loan.

Q. It was given to the partnership at the time of its inception. A. That's right.

Q. November 26, 1948 and December 13, 1948.

A. Yes, transferred over to the corporation.

Q. I see. And so it wasn't until September 15, 1952 that you took a note for \$4,451.00 from the partnership, is that correct? A. Yes.

Q. And what does that note represent—the sum of that note?

A. The money that I loaned the corporation.

Q. Did you loan them more money than is represented by these two checks?

A. No, just what's there plus the Four Thousand that Mr. Fazio gave me which was not in that note, naturally.

Q. You have the sum total of two checks you have here is in the amount of \$3,200.00.

A. Because I can't recall what the other check

(Testimony of Laurence C. Ambrose.)

was but you will find it in the big books. I just found those.

Q. Is this the only contribution you made to the partnership? A. That's right.

Q. So you wrote yourself a check or the partnership gave [12] you a note for the entire amount of your contribution, is that correct?

A. When the thing was turned over to the corporation, this plus some other check I can't find, amounted to that.

Q. I see.

A. And that's why they give back a note when it formed the corporation.

Q. I see. You took this note just before the corporation was formed.

A. No, no, after the corporation was formed.

Q. But this note is dated September 15, 1952. When was the corporation formed?

A. Well, here, it's got the seal on it. They might have dated them the same way as the note but there's the seal.

Q. Well, the note shows the seal of the corporation to say September 22, 1952.

A. Well, I don't know about that.

Q. Is that the date of the incorporation?

A. Probably so as far as I can remember.

Q. What was your job in the corporation?

A. Secretary-treasurer.

Q. You don't know when it was incorporated?

A. I can't recall it, no.

(Testimony of Laurence C. Ambrose.)

Q. So far as you know, this is correct—the figure on this seal? A. That's right.

Q. Now, why were you given this note, Mr. Ambrose?

The Referee: When you say "this note"— [13]

Mr. Dole: I am referring to the note of September 15, 1952.

A. Well, this is the amount they owed me at that time. As I said, I can't recall the rest of the checks; I can't find them. But if you get the books, you will see it in the books.

The Referee: No, Mr. Ambrose, the Court is bearing in mind that there were more than the two checks.

The Witness: There were more than the two.

The Referee: That were presented to the Court to make up this amount.

The Witness: There were but I just can't—

The Referee: Let's assume that all of the checks were here making up that amount. Mr. Dole wants to know why you were given that note.

The Witness: Because the money that I put in the business.

The Referee: Represented by those checks.

The Witness: Represented by those checks.

The Referee: And this note.

The Witness: Cash.

Q. And what was the reason for cancelling this note? A. I didn't cash that note.

Q. Cancelling it.

A. Cancel it, because at that time during the

(Testimony of Laurence C. Ambrose.)

partnership it wasn't a corporation. Then we turned over to a corporation, I had to get up a note back for the money I put in the business [14] in the beginning which that offsets that. That's the transferred note.

Q. This was a partnership note, was it not?

A. That's right.

Q. This is the one of September 15.

A. Yes, that's right, the beginning of the business.

Q. Then when the corporation was formed, you cancelled that note.

A. They cancelled that note and give me a new one.

Q. I know the figure of the new one is \$400.00 less than the figure of the old note.

A. The \$400.00 less was during the time of the business before it closed, I took one of the cars over—an old car, and I cut down my obligation \$400.00.

Q. What kind of—you say you took over a new car?
A. No, an old car we had there.

Q. An old car. A. Yes.

Q. What kind of a car was it?

A. It was a Chevrolet, I think.

Q. Do you remember the year and model?

A. I couldn't tell you that.

Q. You don't remember the year.

A. No, but it's on the books.

Q. Do you still have the car? A. No.

Q. You sold it?

A. I gave the car to my daughter. [15]

(Testimony of Laurence C. Ambrose.)

Q. Does your daughter still have the car?

A. Yes.

Q. Do you remember the year and model of the car?
A. I don't remember it.

Q. Your daughter owns the car that you gave her and you don't know the year and model?

A. I didn't take it in my mind to remember it; I just took the car over the first time I bought the business. I suggest the books you can see it.

Q. I notice this note is just dated fourteen days after the former note.

A. No, sir, on the books I owed the \$400.00; it had been on the books for a long time so when we made up the books, then I had to take that note and cut it down \$400.00. No use me raising the note \$400.00 when I owe the company Four Hundred bucks.

Q. Mr. Ambrose, as secretary it was your duty to record the minutes, all of the minutes of——

A. Yes, you will find it in the minutes.

Q. When did you have the first meeting of the organizers of the corporation?

A. I couldn't remember that.

Q. Do you recall whether or not you recorded the minutes of that meeting?
A. No, I can't.

(Discussion off the record.)

Q. Mr. Ambrose, I'm going to show you this book and ask you what it is.

Mr. Shapro: May I see it first, please? [16]

(Mr. Dole handed the book to Mr. Shapro.)

Q. Now, Mr. Ambrose, I'm showing you this

(Testimony of Laurence C. Ambrose.)

book and asking you what that is. I'm referring now to the whole book, Mr. Ambrose.

A. Just this one page?

Q. No, the whole book as a book, asking you what that book is.

A. Well, referring to the book, it's a minute book.

Q. And was that book kept by you?

A. Well, it was kept in the office and I——

Q. And you were secretary of the corporation, were you not? A. Yes.

Q. Were you in charge of that book?

A. No, we left it in the safe. I didn't take that book home. I just left it at the business.

Q. I know that but didn't you prepare the minutes of the meeting of the board of directors?

A. Yes; after we had the meeting, yes.

Q. And you signed all the minutes.

A. I signed them all after we get through, yes.

Q. And those minutes were kept in accordance with the customary business practice in Leonard Plumbing & Heating Supply Company, Inc.?

A. That's right.

Q. And in the reasonable course of business.

A. That's right.

Q. And they reflect accurately and truly what went on in the meetings—the various meetings of the board of directors. [17] A. That's right.

Mr. Shapro: I object to the question as calling for the opinion and conclusion of the witness what they actually and truly represent.

(Testimony of Laurence C. Ambrose.)

Mr. Dole: He prepared them as the secretary. I think he can answer that question.

The Referee: He may answer. Overruled.

A. I signed them.

Q. What's that?

A. I signed them after the meeting was over.

Q. Do they reflect the business that was conducted at the various meetings of the board of directors, truly and accurately? A. Yes.

The Referee: Mr. Dole, then you had better mark that. Trustee's 1 for identification—the minute book.

(The book referred to was received for identification by the Referee and marked "Trustee's Exhibit No. 1 for Identification.")

Q. Now, Mr. Ambrose, do the minutes which are contained in this minute book truly reflect all of the transactions which took place both at the meeting—meetings of the boards of directors, the meetings of the shareholders and all transactions which the minute book purports to cover between shareholders and directors? A. Supposed to be, yes.

Q. Now, I'm referring to—at this time, to the minutes dated 29th day of September, 1952. Do you recall having a meeting [18] of the organizers of Leonard Plumbing & Heating Supply Company, Inc. on that day? A. I can, yes.

Q. And is this set of minutes consisting of one, two, three, four, five, six pages the set of minutes for that meeting? A. That's right.

(Testimony of Laurence C. Ambrose.)

Q. And was that the organization meeting of the corporation? A. As far as I know, yes.

Q. I'm going to read one of those sets of minutes to you and ask you if that is true and proper.

The Referee: Mr. Doyle, before you do, let the claimants take a look at—point out to them the part you are going to read and let counsel for the claimants take a look at what you have in mind.

Mr. Dole: On page 3 at the place marked to the place marked on page 4. In other words, omitting the first paragraph on page 3, taking the second paragraph clear to the bottom of the page and the first two paragraphs on page 4.

Mr. Shapro: I suggest, instead of reading it—it's rather long—that he let the witness read it.

Mr. Dole: Somebody should read it—I want it read into the record. I don't care who reads it.

Mr. Shapro: I withdraw the suggestion.

Q. Now, Mr. Ambrose, I'm reading from these minutes at the place I have indicated before:

(Reading): "The chairman then answered that the corporation [19] had been formed for the purpose of taking over the existing business of Leonard Plumbing & Heating Supply, a partnership. I stated that the partners in that company had agreed to convey to the corporation all their right, title and interest in and to the assets and goodwill of said partnership in consideration of the corporation assuming all of the outstanding liabilities of the said partnership as at the time of such transfer

(Testimony of Laurence C. Ambrose.)

and agreeing to issue to each of said partners no par value common stock of the corporation as soon as the necessary permit can be secured for the issuance of said stock from the California Corporation Commissioner. The amount of the stock issued would be based upon the actual book value of each of such partner's interest in and to the assets of the partnership. One share of no par value common stock to be issued for each \$10.00 of such value.

On motion duly made, seconded and unanimously carried, the following resolution was adopted:

Resolved, That the office of the partners of Leonard Plumbing & Heating Supply, such partners being Joseph A. Fazio, Bertrand T. Leonard and Laurence C. Ambrose to turn over the assets and goodwill of said partnership to the corporation, be and the same is hereby accepted; and

Be it further resolved, that this corporation take over the said business of Leonard Plumbing & Heating Supply as of the opening of business on the 1st day of October, 1952 and to assume the liabilities of said business as at that time; and

Resolved further that the secretary of this corporation be and he is directed to deliver to the said Joseph A. Fazio, Bertrand T. Leonard and Laurence C. Ambrose one share of the no par value common stock of the corporation for each \$10.00 of book value of their respective interests in and to the assets of the said partnership as soon as a permit for the issuance of said stock is secured from the California Corporation Commissioner and said part-

(Testimony of Laurence C. Ambrose.)

ners to deliver to the corporation a satisfactory conveyance of the property transferred.

The necessity of securing a permit to issue the stock was discussed and on motion made and seconded the following resolutions were unanimously adopted." [20]

I shan't read any further than that. Now, Mr. Ambrose, do those paragraphs which I have just read from your minutes directly reflect—

A. They're true.

Q. (Continuing): —the business which was conducted at the meeting of that particular—

A. That's right, yes.

Q. Of the organizers at that time, Leonard Plumbing & Heating Supply Company, Inc.

A. That's right.

Q. Was there anyone present other than yourself and Mr. Fazio and Mr. Leonard at that meeting?

A. I can't recall it.

Q. Just the three of you were present?

A. Yes, sir.

Q. As far as you know, at any rate. At that meeting, did you consider the financial difficulties of the partnership?

A. What's that?

Q. I say at that meeting did you consider the fact that the partnership had been having financial difficulty?

A. I don't know.

Mr. Crews: I object to that, your Honor, on the ground he is assuming something not in evidence.

The Referee: Sustained.

Q. Mr. Ambrose, I show you now a document—

(Testimony of Laurence C. Ambrose.)

Mr. Ambrose, do you know whether or not the partnership had lost money in the year October 1, 1951 to September 30, 1952?

A. I don't think we lost any money.

Q. You don't think you did.

A. We might have lost some but I think in the business when [21] we were straight partners we didn't lose no money. It wasn't a question of changing the business into a corporation because by losing money; we wasn't losing money. We thought we would turn the thing over to a corporation because we were never there half the time.

Mr. Dole: Your Honor, I request that the answer be stricken as not responsive to the question.

The Referee: Well, the part with reference to during the partnership we didn't lose any money can stay in; the rest of it can go out.

Q. Isn't it a fact that you lost Twenty-two Thousand Five Hundred Twenty-one Dollars and Thirty-four Cents in the period that I have just mentioned?

A. In the corporation or in the other business?

Q. In the partnership—the last year of the partnership.

A. Well, I can't recall those figures. If we did, I can't recall them.

Q. Did you ever discuss the fact of the loss with the other partners at any time?

A. I don't recall it.

Q. You can't recall it is your answer.

A. No.

(Testimony of Laurence C. Ambrose.)

Q. Do you wish to reconsider your testimony that the partnership had never lost any money?

A. We lost money and we made money. There are records there to prove it if you look at your statement. We might have lost money some years; some years we might have made money.

Q. But you don't recall what happened in the years immediately [22] preceding the incorporation?

A. No, I don't. In fact, your Honor, isn't it my question mostly concerning my notes without bringing all that stuff in?

The Referee: Mr. Ambrose, you are represented by your attorneys.

Mr. Crews: We will object, Mr. Ambrose, if we feel it's immaterial.

Q. Mr. Ambrose, the claim against the company or against the corporation here was in the amount of \$7,871.75. You presented a note here in the amount of—

Mr. Walsh: \$7,871.17.

Q. (Continuing): —\$7,871.17 and a note in the amount of \$4,051.17 and you are certain that represents your investment in the partnership that you made in 1948.

A. Yes, but not during that time—

Q. I haven't asked the question. That's correct, as far as we have gone now.

A. That's right.

Q. What does the difference represent between

(Testimony of Laurence C. Ambrose.)

the amount of this note and the amount of your claim?

A. On that and—on the Four Thousand.

Q. The amount of your claim is \$7,871.17.

A. It is, plus the Four Thousand Dollars bonus that was transferred from Fazio to my account. Now, that was transferred to my account. That's why the difference there. You see it in the books.

Q. I beg your pardon, sir, I just don't understand your [23] answer. Would you read it back, please?

The Referee: Is this your answer, Mr. Ambrose? That the total amount in your claim is the amount of one of those notes.

The Witness: That's right.

The Referee: Plus this \$4,000.00 that Mr. Fazio had given you.

The Witness: That's right.

Q. Mr. Fazio had given you \$4,000.00?

A. That's right.

Q. How did he give you the \$4,000.00?

A. Transferred from his account to mine in the business which was cashed and you can see those transfers made way before this place ever closed up.

Q. Was that transfer a part of the capital contribution of Mr. Fazio and the partnership?

Mr. Shapro: I am going to object to the question as calling for the opinion and conclusion of the witness. Capital contribution, that's one of the things your Honor is going to have to pass on.

The Referee: Sustained.

(Testimony of Laurence C. Ambrose.)

Q. He never gave you an assignment of accounts receivable. A. No.

Q. Prior to incorporation or at the time of the incorporation, did you and the other partners have discussions concerning the financial difficulties of the partnership? [24]

Mr. Shapro: I object to the question on the ground it assumes a fact not in evidence. There is no evidence yet that there was any financial difficulties in the partnership.

Mr. Walsh: I think that's a proper question.

The Referee: Did you hear the question?

The Witness: No.

Mr. Dole: You didn't.

The Witness: No.

The Referee: Overruled. Change that question to finances. Financial situation of the corporation instead of financial difficulties.

Mr. Shapro: If amended, I withdraw the objection, your Honor.

Q. Prior to the formation of the corporation, did you and the other partners ever discuss the finances of the partnership? A. No.

Q. You did not. A. No.

Mr. Dole: I have no further questions, Mr. Ambrose.

Mr. Shapro: Just a minute, Mr. Ambrose.

Examination

Q. (By Mr. Shapro): Do you understand what

(Testimony of Laurence C. Ambrose.)

Mr. Dole means by discussion of finances of the partnership? A. Yes.

Q. Tell me what you think it means, please, sir.

A. It means that the business can't carry on its business, that they're short of money. Is that your question? [25]

The Referee: Don't ask Mr. Dole. Just answer Mr. Shapro.

Q. Now, Mr. Ambrose, isn't it a fact that from time to time you and Mr. Leonard and Mr. Fazio discussed how much money was being made or lost or how much money—how much business was being done by the partnership? A. That's right.

Q. To your knowledge, was the fact that the—if it was a fact—that the partnership lost money in 1952 ever discussed between you, Fazio and Leonard or with you or by you with either of the other two gentlemen? A. Yes, we lost money.

Q. And—

Mr. Walsh: Just a minute now, I ask that that answer go out as not responsive.

The Referee: It's not responsive. So ordered. Now, Mr. Ambrose, you listen to Mr. Shapro's question.

Mr. Shapro: Will you read it please?

(The last question was read by the Reporter.)

A. I can't recall it, Shapro.

Q. You can't recall it. When in response to one of Mr. Dole's questions you referred to an assignment or transfer of an account by Mr. Fazio to you

(Testimony of Laurence C. Ambrose.)

in the sum of \$4,000.00 isn't it a fact that you were referring to part of his note for \$4,000.00?

Mr. Dole: Just a minute, if your Honor please. He answered no. His answer was he received no assignment and I object to Mr. Shapro's question, your Honor. [26]

Mr. Shapro: Your Honor please, if we want to have the question read to which the answer was given no, you will find Mr. Dole used the words "accounts receivable."

The Referee: As far as the Court is concerned, I am only interested in the facts. You can answer the question even technically the objection may be good.

A. You mean the total——

Mr. Dole: Just a minute, Mr. Ambrose. I suggest you not make any voluntary statements but answer the questions propounded to you by counsel.

Mr. Shapro: Will you read it please?

(The last question was read by the Reporter as follows: "Question: You can't recall it. When in response to one of Mr. Dole's questions you referred to an assignment or transfer of an account by Mr. Fazio to you in the sum of \$4,000.00, isn't it a fact that you were referring to part of his note for \$4,000.00?")

A. Yes.

Mr. Shapro: No further questions.

Mr. Dole: Your Honor please, so we will have the record clear, is Mr. Shapro questioning Mr. Ambrose under 21(j) or as his own witness?

(Testimony of Laurence C. Ambrose.)

Mr. Shapro: He isn't my witness. I am cross examining him. They called him as their witness.

Mr. Dole: This is 21(j), Mr. Shapro. We didn't [27] call him as our witness. We called him under 21(j).

Mr. Shapro: As far as I am concerned, this is cross examination of the witness. It's called redirect, I know, where the witness is called under cross, but unless it is the client of the party calling him, it is cross examination.

The Referee: Now, so the Court at this time will afford itself of the opportunity of getting the record straight and my question is directed to Mr. Fazio's counsel, Mr. Ambrose's counsel and counsel for the trustee, may everything that has been asked and answered up to now be considered with reference to the objections on both claims?

Mr. Shapro: Yes, your Honor.

Mr. Dole: Yes, so stipulated.

Mr. Crews: Yes.

The Referee: Now, Mr. Shapro, your contention is that even though the witness was called under 21(j) on your client's claim that you have the right to examine him further.

Mr. Shapro: That's right, your Honor.

The Referee: And the testimony may stay.

Mr. Walsh: I'm not objecting to the testimony for the record, your Honor; I am trying to get the record straight is all calling the witness as his own witness or on cross examination. [28]

(Testimony of Laurence C. Ambrose.)

The Referee: Mr. Shapro's contention is that he is calling him on redirect.

Mr. Walsh: Redirect, just to keep the record clear, that's all.

The Referee: Now, Mr. Walsh or Mr. Dole, do you have any further questions?

Mr. Dole: I think I will ask a couple more questions.

Q. (By Mr. Dole): The secretary of the corporation, Leonard Plumbing & Heating Supply Company, Inc. would have prepared an application to the Corporation Commissioner for a permit to issue securities. A. Yes.

Q. Do you have a copy of that application?

A. Well, I wouldn't have it. The attorney would have it.

Mr. Shapro: I have it, Mr. Dole; I gave you a copy of it.

Mr. Dole: May I have a copy of that?

Mr. Shapro: I gave it to you.

Mr. Dole: I have the photostatic copy.

Mr. Shapro: Well, I don't have the original, either. I copied it from Mr. Gericke's file copy which I have here.

Q. Is this a copy of that application?

A. Yes, as far as I know.

Q. Did you sign the original of this application?

A. Yes. [29]

Q. And was this duly submitted to the Commissioner of Corporations? A. That's right.

Q. Did you have prepared as exhibits with this

(Testimony of Laurence C. Ambrose.)

application a balance sheet and profit and loss statement for the year immediately preceding the filing of this application?

A. I wouldn't know; the attorney handled that.

Q. If you were advised in this application that such was an exhibit, would you say that such a financial statement had been prepared and submitted as a part of this? A. I wouldn't know.

Mr. Shapro: For the record, so that there may be no misunderstanding, I have obtained previously and furnished to counsel copies or certified—and a certified copy of Exhibits A & F referred to in the application.

Mr. Dole: I have never seen them.

Q. Did you receive a permit from the Corporation Commissioner, Mr. Ambrose? A. Yes.

Q. Do you have a copy of that permit?

A. I don't have it here unless it's in the books.

Mr. Shapro: I have a duplicate-original of the permit of which I have previously given you a copy, your Honor. I want the record to indicate that if counsel is doing this—asking these for the purpose of comparing these with the photostatic copies, I furnished him, I have no objection. [30]

Mr. Walsh: Your Honor please, let's get the record straight. Mr. Shapro represented the bankrupt. He represents Mr. Fazio and if he has any copies or any documents, we're entitled to see them.

Mr. Shapro: You have already been given copies of them.

Mr. Dole: Is that a copy?

(Testimony of Laurence C. Ambrose.)

The Witness: Yes.

Q. And this permit is dated June 20, 1953.

A. That's right.

Q. Did you subsequently prepare and issue certificates of stock pursuant to this permit?

A. There's stock certificates, yes.

Q. And what date did you issue the stock certificates?

A. I can't recall the dates.

Q. It would be after the date January 20, would it not?

A. I assume it was.

Q. Did you have a profit and loss statement—a balance sheet prepared approximately as of the date you issued the stock certificates?

A. I don't know.

Q. Who would know that?

A. The attorney who made these.

Mr. Dole: I would like to introduce in evidence the permit from the Corporation Commissioner, your Honor.

Mr. Shapro: Well, your Honor, I have no objection [31] as long as I have the right to withdraw it, to make another photostat, having given counsel a copy already.

Mr. Dole: So stipulated.

The Referee: Mr. Dole, you are offering this as Objecting Trustee's No. 2, did you say in evidence?

Mr. Dole: In evidence.

The Referee: So ordered.

(The paper referred to was received in evidence by the Referee and marked "Trustee's Exhibit No. 2 in evidence.")

(Testimony of Laurence C. Ambrose.)

Mr. Dole: I have no further questions of Mr. Ambrose.

Mr. Shapro: Just a minute. As long as the matters have been gone into on examination of this witness, at this time on behalf of the claimant, Fazio, I offer in evidence the copy of the application for the permit about which counsel has interrogated the witness, together with certified copy of Exhibits A & F therein referred to.

The Referee: As one exhibit.

Mr. Shapro: Maybe because one is certified, they better be offered separate. The application first, your Honor.

Mr. Dole: I should think—well, that's all right.

The Referee: Mr. Chew, do you want to join in this offer of the claimant Fazio on behalf of the claimant Ambrose? [32]

Mr. Chew: Yes.

The Referee: So then I'll mark the application as Claimant's No. 1 in evidence.

(The paper referred to was received in evidence by the Referee and marked "Claimant's Exhibit No. 1 in Evidence.")

Mr. Dole: May I see the exhibits, Mr. Shapro?

Mr. Shapro: Surely.

(Discussion off the record.)

The Referee: Mr. Shapro, this next set of documents.

Mr. Shapro: Is a certified copy of Exhibits A & F filed with the Commissioner of Corporations as a part of the application, which is Claimant's No. 1.

(Testimony of Laurence C. Ambrose.)

The Referee: This will be Claimant's No. 2 in evidence.

(The paper referred to was received in evidence by the Referee and marked "Claimant's Exhibit No. 2 in Evidence.")

Q. (By Mr. Shapro): Mr. Ambrose, who was the attorney that represented the corporation in connection with its incorporation and the application for permit to issue stock?

A. Mr. Gericke, I think.

Q. Mr. Gericke. And did the corporation have an accountant at the time of its incorporation?

A. Yes.

Q. And did the partnership have an accountant up to the time of the incorporation? A. Yes.

Q. And who was that accountant?

A. Laborde & Fischer. [33]

Mr. Shapro: No further questions.

The Referee: Mr. Dole and Mr. Walsh or Mr. Chew and Mr. Crews, we are considering both claims.

Mr. Chew: Are we considering all these together?

The Referee: Yes, but you are not bound at this time to examine Mr. Ambrose. You can call Mr. Ambrose later on and develop anything.

Mr. Chew: I would rather do that.

The Referee: You would rather do that.

Mr. Dole: Mr. Shapro, this is a balance sheet which is in somewhat different form than that which you have just introduced in evidence. Would you

(Testimony of Laurence C. Ambrose.)

have any objection to the introduction of that balance sheet?

Mr. Shapro: None whatsoever.

Mr. Dole: Mr. Crews and Mr. Chew, would you have any objection to the introduction in evidence?

(Discussion off the record.)

Mr. Crews: I have no objection.

Mr. Dole: I will introduce that in evidence then as trustee's next in order.

The Referee: Trustee's No. 2.

Mr. Shapro: No. 3, your Honor, may I suggest?

The Referee: Yes, No. 3 is correct.

(The paper referred to was received in evidence by the Referee and marked "Trustee's Exhibit No. 3 in Evidence.") [34]

Mr. Dole: I guess that one for identification has gone in then.

The Referee: The minute book has not gone in. It's marked for identification.

Mr. Shapro: The claimant Fazio will offer in evidence—excuse me, I'm sorry.

The Referee: You have this balance sheet dated October 1, 1952 and it's marked Objecting Trustee's No. 3 in evidence. Now, Mr. Shapro.

Mr. Shapro: Your Honor, the claimant Fazio will now offer in evidence the minute book which has previously been identified as Trustee's No. 1 for Identification and offer it in evidence.

Mr. Crews: That may be joined in by both.

The Referee: As Claimant's No. 3 in evidence.

Mr. Dole: What is that?

(Testimony of Laurence C. Ambrose.)

The Referee: The minute book. It's previously marked Objecting Trustee's No. 1 for Identification. You gentlemen have it.

Mr. Dole: May I see Fazio's No. 2, your Honor?

The Referee: Yes.

Q. (By Mr. Dole): Mr. Ambrose, how much stock do you own in Leonard Plumbing & Heating Supply Company? A. Two Hundred shares.

Q. And how much percentage-wise does represent of the [35] stock issued? A. One-third.

Q. And what was the consideration you paid for that stock? A. Value of \$10.00 per share.

Q. Did you pay cash for that stock?

A. Taken out of the—sure it was paid cash.

Q. And what date and what time did you pay the cash?

A. Well, we paid it at the time the stock was issued. It was cut down from the money in the business I had coming to me.

Q. Do you have cancelled checks such as these?

A. That has nothing to do with that. That's just a different transaction altogether.

Q. Oh, you didn't pay cash then for that stock?

A. Well, if I didn't buy the stock these would be higher. The difference would have been \$2,000.00.

Q. Now, explain what you paid for the stock please, if you will, sir.

A. When the thing was formed into the corporation, we bought two hundred shares.

Q. What did you pay for the stock?

A. Ten Dollars per share.

(Testimony of Laurence C. Ambrose.)

Q. And what *as* that Ten Dollars per share represented by? A. Two Thousand Dollars.

Q. Two Thousand Dollars. How did you pay the Two Thousand Dollars?

A. When the business was formed over in a corporation, it [37] was cut down from what I had in that business then more than that difference but we did make a profit one year, you know, and the money all stood in the business; nobody took any money out of the business. When that business was started, we didn't take out one penny out of that business. I'll take it back—\$150.00 since the business started.

Mr. Crews: Mr. Ambrose, I suggest when you answer the questions, don't say "we" but say who, if any, took money out of the business.

The Referee: You didn't make any money; you drew the hundred and fifty.

The Witness: Nobody took any money out of the business. All laid in the business all the time.

Q. Mr. Ambrose, as a matter of fact, you didn't pay any cash for that stock, did you; it was just a transfer of the assets and liabilities of the business for the stock.

A. It was my share of the profits during the business at the time it was in the partnership business. Then we formed the corporation, naturally, I bought Two Thousand Dollars worth of stock. If I would have got out of the business, they would have gave me Two Thousand Dollars plus this, wouldn't they?

(Testimony of Laurence C. Ambrose.)

Q. (By the Referee): Well, Mr. Ambrose, isn't this what you have in mind? You had an interest in the partnership. A. That's right.

Q. You were one of the partners.

A. That's right.

Q. And according to your understanding, that interest you [38] had in the partnership was worth something.

A. It was worth—that's right.

Q. And when the corporation was formed, for your interest in the partnership, you received so many shares of the stock. A. That's right.

Q. Isn't that exactly what it is?

A. That's right, that's exactly.

Mr. Dole: That's all.

Q. (By Mr. Shapro): Mr. Ambrose, in response to the Court's question, which was the last question just asked that for your interest in the partnership you received stock, did you mean to imply that for your entire interest you received stock?

A. No. No, just part of my interest.

Q. And for the balance you received the note.

A. That's right.

Q. This promissory note for the balance.

A. That's right.

Q. (By Mr. Dole): And you left just Two Thousand Dollars representing your interest.

A. That's right, plus the loan.

Q. And the secretary of the corporation then—I gather then that Mr. Fazio did the same thing; he

(Testimony of Laurence C. Ambrose.)

left Two Thousand Dollars of his account in the organization and took a note for the rest.

A. That's right.

Q. And the other partner, Mr. Leonard, the same thing happened. [39]

A. That's right.

(Discussion off the record.)

Mr. Chew: Your Honor please, I would like to offer into evidence both of these notes, the first one dated September 15, 1952 in the amount of \$4,451.00 17/100 dollars by the Leonard Plumbing & Heating Supply Company signed by J. A. Fazio, B. T. Leonard and Laurence C. Ambrose. I would like to have this one admitted into evidence.

The Referee: Claimant's No. 4 in evidence.

Mr. Walsh: For the purposes of identification, that is the co-partner's note.

The Referee: September 15, 1952 in the amount of \$4,451.17, Claimant's No. 4 in evidence.

Mr. Chew: Also, if your Honor please, I would like to put into evidence this note which I have in my hand here in the amount of \$4,051.17 dated October 1, 1952 between Leonard Plumbing & Heating Supply, Incorporated signed by J. A. Fazio, B. T. Leonard and Laurence C. Ambrose.

The Referee: Claimant's No. 5 in evidence.

(The papers referred to were received in evidence by the Referee and marked "Claimant's Exhibit No. 4 and 5 in evidence," respectively.)

Mr. Crews: Let the record show that that's a corporate note that was issued. [40]

The Referee: Is that all of Mr. Ambrose?

Mr. Dole: I have no further questions.

(Discussion off the record.)

The Referee: Thank you very much, Mr. Ambrose, temporarily. You may be called again by your own attorney or Mr. Shapro.

Mr. Dole: I would like to call Mr. Clifford V. Heimbucher.

CLIFFORD V. HEIMBUCHER

called as a witness on behalf of the objecting trustee, being first duly sworn by the Referee, testified as follows:

Q. (By the Referee): Your full name?

A. Clifford, V. for Victor, H-e-i-m-b-u-c-h-e-r.

Q. And, Mr. Heimbucher, where do you reside?

A. I reside at 2900 Garber Street in Berkeley.

Q. And your business or occupation?

A. I'm a certified public accountant and management consultant.

The Referee: Thank you.

Direct Examination

Q. (By Mr. Dole): Mr. Heimbucher, in connection with your profession, where do you carry on that business?

A. I maintain my office in San Francisco. [41]

Q. And what is the name of your firm?

A. The firm is Farquhar & Heimbucher.

Q. Are you a partner in that firm?

A. Yes, I'm a partner.

Q. And does the management consultant activities of your concern operate under the same name?

(Testimony of Clifford V. Heimbucher.)

A. That is correct.

Q. Are you associated with any other firms in like business?

A. Yes. I also serve as resident manager for Scovell, Wellington Company; that's S-c-o-v-e-l-l W-e-l-l-i-n-g-t-o-n and Company, a national firm.

Q. Now, are you licensed to practice your profession in the State of California, Mr. Heimbucher?

A. I am.

Q. And when were you so licensed?

A. I received my CPA certificate in California in 1937.

Q. Of what college or university are you a graduate?

A. I am a graduate of Columbia University.

Q. And had you had professional or had you had post-graduate work? A. Yes, I did.

Q. And where and when was that?

A. At Columbia University.

Q. Do you belong to any professional organizations or associations in connection with your professional activities?

A. Yes. I'm a member of the American Institute of Accountants, the California Society of CPA's, the New York Society of [42] CPA's and the Washington Society of CPA's.

Q. And have you ever occupied any offices or any positions in any of the societies which you have just mentioned?

A. I am a past president of the California Society of CPA's and also of the San Francisco Chap-

(Testimony of Clifford V. Heimbucher.)

ter of that organization, and a past member of the Council of the American Institute of Accountants.

Q. Now, Mr. Heimbucher, in the course of the activities, I believe you have mentioned it as business management, consultant, is that correct?

A. Management consultant.

Q. Management consultant and CPA. Are you familiar with the problems involved, the capital requirements of beginning businesses and particularly of new corporations?

A. Yes, I've had considerable experience in that field.

Q. And are you able on inspecting the opening financial statements of a new corporation to form an opinion as to the adequacy of the capitalization of that concern? A. I believe so.

Q. How many beginning businesses have you analyzed with respect to your professional activities?

A. I couldn't answer that precisely but it would be a large number.

Q. I understand that. Now, Mr. Heimbucher, I am going to show you now defendant Fazio's—

The Referee: Pardon me, Mr. Dole, before you do, Mr. Shapro or Mr. Chew or Mr. Crews, do you gentlemen [43] desire to ask any questions with reference to the witness' qualifications?

Mr. Shapro: Yes, your Honor.

Q. (By Mr. Shapro): Have you ever analyzed the opening accounts and balance sheets of a corporation engaged in the plumbing supply business?

(Testimony of Clifford V. Heimbacher.)

A. Not that I recall in that particular field, no.

Mr. Shapro: I have no further questions at this time.

Q. (By Mr. Dole—Continuing): Mr. Heimbacher, have you ever analyzed the opening financial statements of concerns engaged in the sales and distribution of goods, wares and merchandise?

A. A substantial number.

Mr. Shapro: I have another question.

Q. (By Mr. Shapro): Mr. Heimbacher, isn't it a fact that the capital requirements of corporations engaged or to be engaged in the sale of various or different types of goods, wares and merchandise in their differences vary? A. Yes.

Q. And if services are sold in connection with or along with goods, wares and merchandise, such a business has a different capital requirement, does it not, from one which is not so engaged?

A. That is correct. Those are all elements to be taken into account. [44]

Q. And the nature of the business—by that I mean the nature of the merchandise itself which is to be sold, is a factor, is it not? A. Yes.

The Referee: Mr. Crews?

Mr. Crews: I was wondering if the State of California Corporation Commissioner at the time this corporation was formed, do they have any minimum requirements for stock—capital requirements?

The Referee: The Court won't rule about that question; I am only concerned now with reference

(Testimony of Clifford V. Heimbucher.)

to the examination pertaining to the witness' qualifications because it appears to the Court that he is going to attempt to give testimony as an expert witness and the Court wants to be satisfied that counsel is satisfied that he is an expert. Now, merely with reference to those type of questions, the Court will hear from either Mr. Crews or Mr. Chew.

Mr. Crews: I'll withdraw that question.

Mr. Shapro: I am not conceding the witness' qualifications, your Honor.

The Referee: I understand, Mr. Shapro, but you have temporarily passed——

Q. (By Mr. Dole—Continuing): Mr. Heimbucher, I will ask you further questions along this subject. Mr. Shapro has raised certain questions about the fact that requirements of a hard goods concern are different [45] from those of a soft goods concern and also where services are rendered by the concern they have special requirements. In the course of your activities in studying and analyzing financial statements of various types of concerns, have you had occasion to take into consideration those various factors which Mr. Shapro has mentioned?

A. I would say that in almost every analysis those factors must be taken into account. That is part of the analysis.

The Referee: Well, the fact whether they do or do not, whether they must or must not—the question is have you——

A. Oh, I'm sorry; yes.

(Testimony of Clifford V. Heimbucher.)

Q. Now, Mr. Heimbucher, I will show you defendant Fazio's Exhibit No. 2, the exhibits submitted with the application to the Corporation Commissioner and I call your attention particularly to the comparative profit and loss statements for the years ended September 30, 1949, 1950, 1951 and 1952 for the Leonard Plumbing, Heating & Supply and also the comparative balance sheets for the same years of Leonard Plumbing & Heating Supply Company and ask you if you have ever seen those before?

A. I haven't seen these particular copies but I believe I have seen another copy of the first statement.

Q. Actually, Mr. Heimbucher, the document that I let you inspect before was a pencilled document.

A. That is correct.

Mr. Dole: Do you concede, Mr. Shapro, that these are identical? [45]

Mr. Shapro: I do.

Q. Mr. Heimbucher; I wish also to show you Trustee's Exhibit No. 3, the opening balance sheet dated October 1, 1952 and ask if you have ever seen that document before, Mr. Heimbucher?

A. Yes, I have.

Q. And I believe that was in your office both yesterday and several days prior to that when I showed those documents to you.

A. That is correct.

Q. From those statements which you have in your hand, Mr. Heimbucher, are you able to form

(Testimony of Clifford V. Heimbucher.)

an opinion as to the adequacy of the capitalization of Leonard Plumbing & Heating Supply, Inc.?

Mr. Shapro: Your Honor, if the witness is directed to answer the question yes or no and no other, I will have no objection.

The Referee: He is directed.

A. Yes.

The Referee: You are familiar.

The Witness: Yes.

The Referee: And before you answer this next question, afford Mr. Shapro an opportunity to——

Q. As revealed in these statements, what would you say is the actual usable amount of capital available to this concern?

Mr. Shapro: I am going to object to that question, if your Honor please, upon the ground it's incompetent, irrelevant and immaterial, no proper foundation laid. I take the position, if your Honor please, first, in [46] connection with the objection that it's neither incompetent, irrelevant or immaterial, the subject-matter of this inquiry is not the *property* subject of expert testimony. Secondly, this witness is not qualified by his own admissions to pass an opinion upon the capital requirements of a business such as this because he has never analyzed, among other things, he has never analyzed the capital requirements of a business such as that in which Leonard Plumbing & Heating Supply Company was engaged, namely, the sale of plumbing supplies. He has testified that the nature of the consideration is an element—the nature of

the merchandise to be sold is an element in the determination of such a thing. Going back, if I may, your Honor, to the first objection, whether or not a business has or has not an adequate capital is not the subject of expert testimony, in my opinion where as in this case the nature and consideration of the objection are these (I am referring now to page 2 of the trustee's objections to the claim of Mr. Fazio): That the amount set forth in the claim filed by said J. A. Fazio (I'm reading beginning line 21, gentlemen) represented a portion of the capital investment in said copartnership, that at the time said business was incorporated, all of the capital investment, including that of said J. A. Fazio, was converted from the partnership capital account to an account entitled "loans from [47] copartners," that in truth and fact this transaction was a scheme and plan to place said copartners in the firm of Leonard Plumbing & Heating Supply and the bankrupt corporation thereafter organized Leonard Plumbing and Heating Supply, copartnership, that if said claimant is permitted to share in the assets of said bankrupt now in the hands of the trustee in the same Leonard Plumbing & Heating Supply, he will receive a portion of the capital invested which should be used to satisfy the claims of creditors before said bankrupt"; and on the subject further, your Honor, that no proper foundation has been laid for this question or the question of this—the pending question to this witness, in addition to what I believe would be a failure to show adequate qualifications, there has been no

showing here if the Court please, that any of the creditors of the bankrupt corporation who were such at the time of the organization of the corporation, the issuance of the stock and the transfer to the corporation of the assets of the partnership still remain creditors, and I make the objection, if your Honor please, upon each and all of the grounds I stated.

The Referee: With reference to the last objection that you made, the Court will sustain the objection. With reference to Mr. Heimbucher's qualifications, the Court will overrule your objection.

Mr. Walsh: Your Honor, so we may understand, the last objection was the one relating to the creditor?

The Referee: No showing that there were any creditors that were in existence.

Mr. Dole: That's correct. We will agree there.

The Referee: Gentlemen, this is a good time for me to break.

(Discussion off the record.)

The Referee: In any event, this is a good time for a recess. Mr. Heimbucher, the Court is responsible for you requiring to return, not the attorneys, and if you will excuse me, we will try to arrange a date that's agreeable all around.

Mr. Walsh: Your Honor please, before you make that ruling of sustaining the objection, may we have an opportunity of arguing the law on that before you sustain the objection?

The Referee: The Court will listen to your argument. In other words, Mr. Shapro will not

have to restate the objection because it's in the record. And I will hear from you gentlemen.

Mr. Walsh: Then for the record, it's considered that you are sustaining the objection at this time.

The Referee: I am sustaining the objection but I am going to afford counsel for the objecting trustee an opportunity to convince the Court that it's wrong [49] immediately upon adjourning.

Mr. Dole: The thing of the objection only went, so far as the statement of Mr. Shapro is concerned, that it hasn't been shown that there were creditors in existence now who were creditors of the partnership.

The Referee: Correct. I sustained his objection on that basis.

Mr. Dole: I don't argue that point.

The Referee: Then we are in accord. And as far as Mr. Heimbucher's qualifications are concerned, I overruled Mr. Shapro's objection against it that he is an expert witness.

Mr. Dole: Yes, Mr. Heimbucher can come back and testify.

The Referee: Correct.

(Discussion off the record.)

The Referee: Continued to January 25 at 10:00. And for the record, gentlemen, what is your desire with reference to the exhibits? Mr. Shapro at one time stated that he be allowed to withdraw an exhibit or exhibits.

Mr. Shapro: There is only one I would like to withdraw for the purpose of having a photostat prepared.

The Referee: Let the record show that Mr. Shapro has withdrawn the permit which is——

Mr. Shapro: Which is No. 2—Objector's No. 2— [50] and I would also like to withdraw for the same purpose, Claimant's No. 1.

(Discussion off the record.)

Mr. Shapro: I would like the same privilege with respect to Claimant's No. 1, your Honor.

The Referee: How about the objecting trustee?

Mr. Dole: There is nothing I wish for use, your Honor.

The Referee: The Court then is omitting the minute book; the exhibits will be available to counsel on either side at my office.

Mr. Dole: And then you will instruct all witnesses under subpoena to appear again.

The Referee: All witnesses are instructed to return—all those witnesses who have been subpoenaed, and the record at the start indicated that Mr. Leonard was not present but the Court sees Mr. Leonard present.

Mr. Shapro: I asked Mr. Leonard and had conveyed a request that Mr. Leonard appear. He is not under subpoena. I have no desire for him to return.

Mr. Dole: He is not under subpoena.

Mr. Shapro: Then Mr. Leonard may be excused.

The Referee: As far as both sides are concerned, Mr. Leonard you are excused. If you desire to remain, you may do so. January 25th at 10:00.

(The hearing was adjourned until January 25, 1956 at 10:00.) [51]

January 25, 1956—10:00 A.M.

The Referee: In the matter of Leonard Heating & Plumbing, let the record show that the same appearances are present and at the conclusion of the last hearing, counsel for the objecting trustee reserved the right and the Court granted the right to attempt to convince the Court that the Court was in error with reference to sustaining the claimant's objection with reference to the introduction of certain testimony.

Mr. Dole: Well, your Honor, let me understand here. You are permitting the testimony to go into the record——

The Referee: Well, first of all, Mr. Dole, the Court made a ruling. Mr. Shapro made four or five objections to the question and the line of testimony and the Court overruled all of his objections except one and sustained the objection with reference to creditors in existence.

Mr. Dole: That's correct.

The Referee: And after the Court made its ruling, Mr. Walsh requested that you and he be afforded an opportunity to have the Court change its mind with reference to sustaining the objection on the ground of the creditor in existence. Is that as you recall it, Mr. Walsh?

Mr. Walsh: Yes, that's correct. [52]

Mr. Dole: That's as I recall it, too. If the objection had been overruled on other grounds, then that permits us, as to those grounds—that permits this testimony to go into the record, is that correct?

The Referee: Correct, but in the event that you

gentlemen have nothing further to offer, the Court is going to make a change in its ruling and also a suggestion because once again I am only interested in all of the information and testimony that I can receive. And I will permit Clifford Heimbucher to testify and I will overrule all of Mr. Shapro's objections and I will permit Mr. Shapro and Mr. Crews and Mr. Chew to call, in the event they so desire, the same type of an expert to counteract any testimony given.

Mr. Dole: Yes. Very well. Mr. Heimbucher, would you come forward please?

The Referee: Let the record show that Mr. Clifford V. Heimbucher is on the stand and he was previously sworn.

CLIFFORD V. HEIMBUCHER

having been previously sworn, resumed the stand and testified further as follows:

Direct Examination

Q. (By Mr. Dole—Continued): Mr. Heimbucher, we had examined you with regard to qualifications previously but I will ask you one more question in that line, and that is, in your dealings with other [53] businesses and in considering the financial structure of beginning corporations, had you ever dealt with companies engaged in the so-called hard goods, that is, goods similar to plumbing and heating supply houses?

A. Yes, a very large number.

Q. And what sorts of companies were those?

(Testimony of Clifford V. Heimbucher.)

A. Well, one particular one that I think I did is quite close in nature is the wholesaling of electrical equipment and supplies.

Q. I see. Your Honor, at this time, could we have certain of the exhibits?

The Referee: Surely.

Q. (Continuing): I'm referring specifically now to Trustee's No. 3, Mr. Heimbucher; I believe you had these previously. A. That is correct.

Q. And is this one there identical to those—we already have the stipulation that the accountant's work sheet is the same as the Claimant's Exhibit No. 2, I believe—Trustee's No. 3. Are you familiar—

Mr. Shapro: It's the same as Trustee's No. 3. No. 2 is the permit.

Q. That's correct. Are you familiar with those documents, Mr. Heimbucher?

A. Yes, I have examined them before.

Q. You have examined them prior to this date. Mr. Heimbucher, from these statements, financial statements, are you able to form an opinion as to the adequacy of the capitalization of Leonard [54] Plumbing & Heating Supply Company, Incorporated? A. Yes, I believe so.

Q. Then what is your opinion generally as to the adequacy of the capitalization of that concern, the business herein?

Mr. Shapro: To which question, if your Honor please, we enter an objection upon each and all of the grounds heretofore urged to substantially the

(Testimony of Clifford V. Heimbucher.)

same question asked and objected to at the last hearing on the 17th of this month.

The Referee: Overruled. You may answer.

A. I would say that based upon my experience with similar size concerns that the opening capital is inadequate.

Q. From these financial statements, are you able to form an opinion as to the actual usable amount of capital available to this concern and at its inception?

Mr. Shapro: Same objections.

The Referee: Would you gentlemen be willing to stipulate that Mr. Shapro will have an objection to each and all of these questions without the necessity of so stating each of them and the Court will rule the same? And in the event that he has any other grounds of objection he can specifically state.

Mr. Shapro: That's agreeable with me, your Honor.

Mr. Dole: That's agreeable.

Mr. Shapro: The grounds are those stated at the last hearing, primarily. [55]

The Referee: Correct. The Court's ruling is that the objections are overruled. You may answer.

A. In terms of usable capital, I presume you mean the total usable capital which I would say is the amount of \$6,000, but going further as to working capital there doesn't seem to be any whatsoever because I know that the current liabilities exceeded the current assets so there is an actual

(Testimony of Clifford V. Heimbucher.)

deficiency in working capital on the opening day of business of the corporation.

Q. I see. And by how much is revealed on those statements to opening liabilities exceeding the assets?

Mr. Shapro: I submit, your Honor, the document is the best evidence.

The Referee: Sustained.

Q. Now, Mr. Heimbucher, based upon your experience in converting from a partnership to a corporation as this concern has done, have normal portions of the investment accounts been converted to capital and loans? A. I would say no.

Mr. Shapro: To that question, just a minute please, if your Honor please, in addition to the previous objections made and which are standing to this question, I object on the further ground that it calls for the opinion and conclusion of the witness in a matter of expert testimony. That is one of the very issues your Honor is going to have to pass upon in this case.

Mr. Dole: Obviously, in the first place, it does [56] call for the opinion of the witness. That is what the witness is here for—to give his opinion as an expert in this field. That's the very reason he has been called.

Mr. Shapro: If your Honor, if you listen to the question, you will see that he gave his opinion as to the inadequacy or alleged inadequacy of the opening capital. His opinion as to how much was usable capital, how much, if any, was working cap-

(Testimony of Clifford V. Heimbucher.)

ital. He is now being asked as to whether or not in the transition from the partnership to the corporation, the proper amount of capital was—the proper amount of working capital was transferred, that is the actual issue that your Honor is going to pass upon. It is true, your Honor please, that expert witnesses may give testimony on certain objections and your Honor has so ruled with, of course, due deference that we disagree. On the other hand, in this particular question he is asked—the witness is asked the very question that on—one of the very questions that your Honor is going to have to rule upon—the propriety of this transfer.

Mr. Dole: No, no, I beg to differ there. I merely asked him have normal proportions in a transaction such as this been converted to capital and loan accounts.

Mr. Shapro: I don't think that was your question, Mr. Dole.

Mr. Dole: Yes. [57]

Mr. Shapro: Maybe I misunderstood.

(The last question was read by the Reporter.)

The Referee: Sustained. The answer may go out.

Q. Now, Mr. Heimbucher, in converting from a partnership to a corporation has normal business procedure been followed with respect to the treatment of capital and investment accounts—of capital and loan accounts?

Mr. Shapro: To which question I urge the objection that no proper foundation is laid and that

(Testimony of Clifford V. Heimbucher.)

the subject matter of that question is not the subject of expert testimony.

The Referee: Overruled.

A. No.

Q. Will you explain your answer, Mr. Heimbucher?

A. I will explain it because in my experience generally in converting a business already in existence where the approximate amounts of permanent capital needed in the business have been established by experience, generally in converting to a corporation that amount of capital at least is in my setup as permanent capital in some form generally as common stock or preferred stock and only additional capital needed temporarily is normally set up as loans. But based upon the financial statements which I have before me, would seem that based upon several years' experience the amount of capital employed in the business was at all times substantially more than the \$6,000.00 employed in the opening of the corporation. [58]

Q. Then what deviations then, Mr. Heimbucher, from the portions normally assigned to capital and loans have taken place in this particular instance?

A. Only a very small fraction of the amount which would normally be considered permanent capital has been set up as permanent capital for the corporation and most of it has been set up as loans.

Q. I see. Do you have an opinion, then, Mr. Heimbucher, as to the reasons for these deviations from what we might call normal or good business

(Testimony of Clifford V. Heimbucher.)

procedure? A. Well, my—

Mr. Shapro: Just answer that yes or no, please.

The Referee: Do you have an opinion?

A. Yes.

Q. Would you state that?

Mr. Shapro: I object, your Honor please, upon the ground that it calls for the opinion and conclusion of the witness. That's the very question your Honor is going to have to answer in this case.

The Referee: Sustained.

Q. Mr. Heimbucher, from the financial picture that you have there as indicated by these various statements, would Leonard Plumbing & Heating Supply Company have a reasonable hope of financial success in this enterprise?

Mr. Shapro: I'm going to make an objection to that question upon the ground no proper foundation has been laid. There are too many items going into the hope of [59] financial success for this witness to qualify, particularly when he has never had any experience with the operation of a business even closely resembling this. In other words, his opinion as to capital generally and inadequacy is one thing; his opinion as to whether it has no hope of financial success calls for the opinion and conclusion of the witness, and also the conjecture of the witness.

The Referee: Overruled.

A. I would say it would have very little hope in view of the fact that for the year immediately preceding the opening of the corporation losses

(Testimony of Clifford V. Heimbucher.)

were running at a little less than \$2,000.00 a month on the average and starting with only \$6,000.00 capital it is quite apparent that barring some entirely new matter not apparent here, there would be practically no hope of success.

Q. I see. In your opinion, Mr. Heimbucher and again based upon these records that you have examined, would you say that this was a well-managed concern?

Mr. Shapro: I object to that question, if your Honor please, upon the ground no proper foundation is laid and it calls for the opinion and conclusion of this witness. This man is not a manager—a management consultant.

The Referee: Sustained.

Q. Could any of the deviations from normal business practice [60] and procedure in this financial statements that you have observed here be considered as evidence of poor management?

Mr. Shapro: I make the same objection, if your Honor please. That's an indirect way of accomplishing the same purpose.

Mr. Dole: Your Honor, I'm going to make an offer of proof at this time. As you perhaps have gathered at this point these objections are not based upon fraud. They don't turn upon the existence or non-existence of the debt which is involved. Rather, the only thing that we are concerned about here is the order of payment. Now, these objections as to subordination, these particular alleged creditors and the order of payment involved are based

(Testimony of Clifford V. Heimbucher.)

upon what is known as the Deep Rock Doctrine and this is sometimes known as the Doctrine of Equitable Subordination. Now, that doctrine was established in the case of Taylor against Standard Gas & Electric Company, it's a Supreme Court case at 306 U. S. 307, and in that case the court held that it would scrutinize the good faith and fairness of any transaction in which controlling shareholders of a corporation made loans to themselves and in the event there were accounts indicating loans to those controlling shareholders, it would subordinate those loans to the claims of other creditors in the event that concern had been inadequately capitalized. Now, the first case, that leading case of [61] Taylor against Standard Gas & Electric Company is known as a Deep Rock case because Taylor was a sole owner of a subsidiary known as the Deep Rock Oil Company and that involved the transactions between a parent and a subsidiary company. Now, just two years later, in the Supreme Court case of Pepper against Lytton, that's 308 U. S. 295, that same principle was supplied to the case of an independent shareholder and his transactions—controlling shareholder in line of his transactions in his own corporation. And in that case, the Court went on further saying that this was a case in equity in which the Bankruptcy Court had complete jurisdiction not only to decide the question of the Deep Rock Doctrine involved but any other equitable doctrine involved, the fairness and good faith of those shareholders in setting up the cor-

(Testimony of Clifford V. Heimbucher.)

poration originally. It went on to say also a matter which we haven't pressed here, that when objection has been made to the claim of a controlling shareholder in a close-held corporation that the burden of proof lies upon that shareholder to show his good faith of that transaction.

Mr. Shapro: If your Honor please, they undertook the burden and assumed it.

Mr. Walsh: Just a minute. To keep the record straight, I'll answer that question. We assumed the burden of going ahead and objection but when this question [62] comes up on the fairness and adequacy, the burden shifts to the claimant, if your Honor please; no question about that.

Mr. Shapro: There is a question.

Mr. Dole: So now, your Honor, we are not considering the existence or non-existence at this time; all we are considering here is the order of payment. In other words——

The Referee: The Court is in accord with everything you said, Mr. Dole, but I still sustain the objection. The Court naturally would——

Mr. Dole: Very well. I made my offer of proof.

The Referee: In any event, the Court will sustain the objection and as far as I am concerned, in my determination of this matter the question that you are asking now will not be a part of the record. However, for the protection of the objecting trustee, the answer may go in the record. Is that agreeable?

Mr. Walsh: That's agreeable.

(Testimony of Clifford V. Heimbucher.)

Mr. Dole: I should go on just a little bit further and show in these Supreme Court cases and in the other cases following they have usually said sometimes but not all the time inadequate capitalization is causeous with mismanagement of one form or another or poor management of one form or another and the Court has considered those aspects of the case as well as the [63] aspect of inadequate capitalization and that's the reason I asked Mr. Heimbucher these particular questions.

Mr. Shapro: I hope, may the record show, that by my silence I am not agreeing with all of the conclusions counsel has stated.

The Referee: The record may so show.

(The last question was read by the Reporter as follows: "Question: Could any of the deviations from normal business practice and procedure in these financial statements that you have observed here be considered as evidence of poor management"?)

A. Based upon the financial statements which I have, I would say that as far as financial management at least is concerned, the management was very poor.

The Referee: Well, now, just a minute. Even in the face of my sustaining the objection that question is not entirely responsive. He said as far as financial management is concerned. When you said that, do you want the Court to believe or your attorneys to believe that there are other types of

(Testimony of Clifford V. Heimbucher.)

management? For instance, running a job of hiring men and so forth, or why do you qualify it?

The Witness: What I have in mind is that there are many attributes of management and I am examining this from a financial standpoint and to me the [64] financial results indicate poor management.

The Referee: So your answer is on the financial management, is that right?

The Witness: That's right.

Mr. Dole: Now, there was one more question, I believe besides that one that you just read.

The Reporter: I don't have any other question.

Mr. Shapro: That's the last question.

Mr. Dole: I don't have any other questions.

Mr. Shapro: Your Honor may the record show—I am not trying to be overly technical—may the record show that in undertaking cross examination of the witness on items of testimony that he has given over our objection which your Honor has overruled that I am not waiving those objections?

The Referee: The record may so show.

Cross Examination

Q. (By Mr. Shapro): Mr. Heimbucher, you testified on direct examination that there was no working capital and you are basing all of your conclusions upon that information which you have testified and examined, namely, the comparative balance sheets, comparative profit and loss statements for the first two years and the opening balance sheet of the corporation, is that right, sir?

(Testimony of Clifford V. Heimbucher.)

A. That is correct.

Q. Now, if, Mr. Heimbucher — withdraw that. Working capital such as you have described as being in effect [65] non-existent in this case is used or would be required for what purpose in the business?

A. For financing all current operations such as the purchase of inventory, the accumulation of receivables, maintaining a cash reserve in the bank, paying payrolls.

Q. Having in mind, Mr. Heimbucher, that as of October 1 according to the balance sheet which you have before you, the inventory taken at the lower or cost of market was \$120,000 plus and if one hundred per cent of the credit sales of this corporation were available for immediate financing by the American Trust Company without any deduction of reserve, would you say that that would contribute to the acquisition or the having by the corporation of working capital? A. No.

Q. You would not. A. No.

Q. In other words, it's your testimony, Mr. Heimbucher, as a management consultant and a certified public accountant of some years' experience that having in mind the sales which you have seen from the comparative profit and loss statement of this business for the three years prior to its incorporation and having in mind the inventory that it had during the three years as a partnership and having in mind the inventory that it had as a beginning corporation and that all of those

(Testimony of Clifford V. Heimbucher.)

credit sales were available for a hundred per cent financing, financing on a hundred per cent basis, that you would say that would not contribute to the availability of working capital for that corporation, is that right? [66]

A. Well, working capital is the excess of the current assets over current liabilities. Financing of receivables really increases current assets and current liabilities by equal amounts and the net change or working capital is payroll.

Q. The net change or working capital as defined by an accountant from an accounting standpoint is still nil, doesn't increase. However, from the angle of working capital as defined in the practical sense as distinguished from the accountant's sense of the word, it would provide, would it not, Mr. Heimbucher, the availability of cash for the purchases, the cash for the payroll, the cash for operating expenses as long as the sales did not exceed the ratio that they would for the three previous years.

A. I'm sorry, I don't know any difference between the practical differentiation and the accounting differentiation.

Q. When you testified, Mr. Heimbucher, that there was very little hope of success of this business, did you also have in mind that although the partnership for the fiscal year ended September 30, '52 showed an operating loss of twenty-two thousand-odd dollars, that the same partnership made a profit of \$40,000 in the fiscal year '51 and made a

(Testimony of Clifford V. Heimbucher.)

profit of eighteen thousand, nine hundred for the fiscal year 1950?

A. Yes, I very definitely took that into account. To my mind that was an important factor because the trend seemed to me to be of considerable importance.

Q. You don't know what caused the trend.

A. No. [67]

Q. In other words, you don't know, for instance, and you could not therefore base the opinions you gave this court upon the reduction in sales from fiscal year '51 from \$665,000 to fiscal year '52 of \$389,000. A. No.

Q. Did you examine the relative percentages of gross profit on sales for the three years?

A. Yes.

Q. And did you find any substantial inconsistency?

A. I don't recall the figures on that point. I took them into account in forming my conclusions.

Q. Well, you have the figures in front of you, sir. Would you mind looking at them?

A. Over the period of four years there has been a gradual decline in profit in my opinion.

Q. Would you—— A gradual decline of profit in my opinion. That's ratio of gross profit to sales, is that right? A. That's right.

Q. Will you indicate to me the steps of the decline? In other words—— Withdraw the question. Take a look at the fiscal year September 30, '49

(Testimony of Clifford V. Heimbucher.)

and you will find \$29,000 gross profit or sales of one hundred twenty-eight,—

A. Which is approximately twenty-three per cent.

Q. Right. And you will find for '50, sixty-six thousand or 385.

A. Approximately 17 per cent.

Q. And in '51 you will find 107 or 665 which is about what? A. Sixteen per cent.

Q. Are you sure? A. These are— [68]

Q. Estimates. I'm not trying to hold you to an exact calculation, sir.

A. Approximately sixteen.

Q. And for fiscal year '50, fifty-three thousand on 389 in sales. A. Slightly under fourteen.

Q. The question that I asked you was whether or not in effect there was any marked difference between the three. Your answer—I mean, the answer that I have is that there is gradual reduction as indicated by these estimates that you have made.

The Referee: Your answer is yes, Mr. Heimbucher.

A. Yes, correct.

Q. In connection with your reaching the conclusions that you have testified to today, Mr. Heimbucher, did you take into consideration the identity of the actual management of this business?

A. By that do you mean the individual people?

Q. Yes, sir.

A. No, I do not know that.

Q. Did you take into consideration the fact that

(Testimony of Clifford V. Heimbucher.)

the management and I again mean personal, the individual, the personal management of this business was not— Well, withdraw that. Did you take into consideration the personnel of management for any of the four years involved?

A. Not as individual people, if I understand you correctly.

Q. That's right. Did you know or do you now know the individual experience of the actual person or persons managing this business?

A. Only as reflected in the results of four years' operations. [69]

Q. And the results of four years' operations are those as indicated on the documents you have examined? A. That is correct.

Q. Have you ever seen—by seen, I mean come in personal contact—with in your personal activities a situation where a partnership business was converted into a corporation and any of the partnership capital was withdrawn from the business prior to incorporation? A. Yes.

Q. In cash or property? A. Yes.

Q. Have you ever run into a situation where the same thing was done by the converting of partnership capital into obligations? A. Yes.

Q. Of the corporation? A. Yes.

Q. And in all those cases have the businesses failed? A. No.

Q. In all those cases was the difference in your mind being the amount of capital left after the withdrawal or the conversion into obligations?

(Testimony of Clifford V. Heimbucher.)

A. May I ask are you asking me in all the cases where failures did not occur?

Q. Yes.

A. It is my opinion that the reason it didn't occur was because the capital proportions were different from this?

Q. Yes, that's my question, sir. You have stated it much better than I have.

A. The only word—I would answer yes, with one exception, [70] that the word "all" is a little different to cope with in that question. I don't think that I can apply—say that it's always true of any situation.

Q. In other words, Mr. Heimbucher, it is possible under conditions with which you have not been made familiar and which may have existed for this corporation to have succeeded despite the defects in its capital structure as opined by you.

Mr. Dole: Your Honor, I don't think that question is definite enough to be answered and object to it on that ground.

The Referee: Do you understand the question?

A. Yes, I think I already covered it in my answer to a previous question where I said that—I think I mentioned barring some entirely unexpected development. In other words, if this company were to have some wholly unexpected windfall of some kind then the result might be different.

Q. Having in mind—

The Referee: Pardon me, Mr. Dole, but you withdraw the objection, I assume.

(Testimony of Clifford V. Heimbucher.)

Mr. Dole: Yes, I do. (Laughter.)

Q. Having in mind, Mr. Heimbucher, that the partnership operations as indicated on Claimant's Exhibit No. 2, which is comparative profit and loss and balance sheets indicated a substantial profit for another year, a very small loss for the first year and a \$22,000 loss for the year preceding the incorporation and also having in mind that there was no withdrawal of [71] capital in the conversion of the partnership to the corporation but merely the evidencing of a substantial portion of the partnership capital in the form of notes and that those partners became the stockholders of the corporation, would that in any way affect your opinion as to the possibility of success of this corporation?

A. Only if the evidencing of a portion of their capital by notes was a mere matter of form and it was fully the intention to consider the efforts behind those notes as being permanent capital of exactly the same kind as the stock.

Q. And you have no such evidence brought before you in this case before you made your conclusions.

A. I'm not sure I understand.

Q. No evidence indicating that there was any intention to consider these notes by the noteholders as permanent capital.

A. Only if I could form an opinion from the fact that during the preceding four years that would be treated as permanent capital.

Mr. Shapro: No further questions.

(Testimony of Clifford V. Heimbucher.)

Redirect Examination

Q. (By Mr. Dole): Just one question, Mr. Heimbucher. Do you make a distinction between what you might call debt capital and invested capital? A. Oh, very definitely.

Q. And what is that distinction?

A. The distinction is that debt capital is an obligation to be paid before stockholders would receive on liquidation any [72] assets for their stock whereas invested capital is capital invested in the form of equity, namely, common stock or preferred stock, which would receive assets last on liquidation.

Q. Now, how much of the capital of this concern is represented by debt capital and how much by investments or invested capital?

A. As at September 30, 1952, namely, the last day of the partnership, the total invested capital would be approximately fifty-one thousand six hundred twenty dollars. On one day later, on October 1, 1952, on the opening of the corporation the invested capital would be six thousand dollars.

Q. And how much would the debt capital be?

A. The debt capital would be the difference—forty-five thousand, six hundred dollars.

Q. Would you consider then also any other outstanding indebtedness of the new business in arriving at that figure?

Mr. Shapro: May I have the question read?

(The last question was read by the Reporter.)

Mr. Shapro: Arriving at what figure?

The Referee: He is going to change the question.

(Testimony of Clifford V. Heimbucher.)

Mr. Dole: Yes, I can rephrase the question.

Q. Is that only considering the obligations, the notes taken by the individual shareholders themselves? A. Yes.

Q. I see. You are not considering any other obligations of the concern. A. No.

Q. Any other notes payable. A. No. [73]

Mr. Dole: No further questions.

Mr. Shapro: No further questions.

The Referee: Mr. Chew and Mr. Crews.

Mr. Dole: You may be excused, Mr. Heimbucher. I would next like to call Mr. William B. Logan.

WILLIAM B. LOGAN

called as a witness by the objecting trustee, being first duly sworn by the Referee, testified as follows:

The Referee: I didn't hear the middle initial.

The Witness: William B.

The Referee: B like in Bernard. And your business or occupation?

The Witness: Business analyst, business consultant or the firm of—

The Referee: You don't have to go into those details but I assume that counsel will. But you are in that business and where is your business office located?

The Witness: 400 Montgomery Street, San Francisco.

Direct Examination

Q. (By Mr. Dole): Mr. Logan, what is the name of the business with which you are associated?

(Testimony of William B. Logan.)

A. The name of the company?

Q. Yes.

A. William B. Logan & Associates.

Q. And would you describe the nature of that business?

A. We're a combination of business analysts. I have a group of associates who are primarily retired executives, men [74] of forty or forty-five years assist in their particular field. We also act in the capacity of, you might say, professional managers in staying with a business for a period of a year or two years in guiding them. In several cases our staff is on the board of directors of some of these companies and we have them on a retainer whereby we serve on their management board, review their monthly operation and make suggestions for either improvement or continuous counseling.

Q. How long has William B. Logan & Associates been in existence?

A. About thirty years.

Q. Mr. Logan, where did you receive your college education?

A. I went to Lehigh University, B.S. Degree in industrial engineering.

Q. I see. And what generally has been your business background following your university education and preceding the organization of William B. Logan & Associates?

A. I did some work prior to that. I spent a couple of years in the service where I was an aircraft maintenance officer — administrative officer,

(Testimony of William B. Logan.)

and our primary jobs were to go to air bases and set them up, organize them, when they were organized why go off to another air base. I did some special work for Pan Am, La Guardia Field in setting up shop work, scheduling for the men some special work for Enterprise Engineering & Foundry Company in setting up production schedules and so forth. I had several years' experience—couple of years' experience with the National Business Consultant Firm as a business engineer [75] and for them considerable, I would say, research and study on small business management problems.

Q. Do you consider yourself in your business as specializing in the small business field?

A. Yes, I think actually that we are the only such organization in the country set up as we are and who have geared themselves to small businesses.

Q. Now, are you familiar with the businesses which deal in the sale and distribution of so-called hard goods?

A. Hard goods? Yes. I answer the question yes.

Q. Specifically, have you ever in your experience in the past dealt with businesses engaged in the sale and distribution of plumbing and heating supplies?

A. Yes, retail, wholesale and contractors.

Q. I see. To go back just a minute, are you a member of any professional organizations or associations?

A. Well, I was elected member of the American

(Testimony of William B. Logan.)

Institute of Management. That's the only one I have any time for principally.

Q. Now, Mr. Logan, are you familiar with the problems involved, the capital requirements of beginning businesses and particularly of beginning corporations? A. Yes.

Q. And are you able on inspecting the opening financial statements of a new corporation to form an opinion as to the adequacy of the capitalization of that particular concern? A. Yes. [76]

Q. Mr. Logan, I'm going to hand you here Claimant's No. 2——

The Referee: Before you do, Mr. Dole, have you completed with reference to Mr. Logan's qualifications?

Mr. Dole: I have.

The Referee: Mr. Shapro?

Mr. Shapro: I have no questions to ask the witness at this time. I do not at this point concede his qualifications because I first have to hear the professional questions that are going to be propounded to him. In other words, if he were an accountant, I would know it but he is not an accountant so I would have to wait until the questions are asked.

The Referee: Mr. Chew, do you feel the same way as Mr. Shapro?

Mr. Chew: Yes, your Honor.

The Referee: Mr. Crews?

Mr. Crews: I wouldn't concede that he is an

(Testimony of William B. Logan.)

expert for the purpose that they are calling him, not knowing what they are going to ask him.

The Referee: Very well.

Q. Now, Mr. Logan, I hand you Claimant's Exhibit No. 2 which consists of a comparative profit and loss statement and comparative balance sheet for the four years preceding the incorporation of Leonard Plumbing & Heating Supply Company, Incorporated, and I show you also the work sheet, Mr. Logan, from [77] which that statement was prepared. I think you will find they are identical. They have been stipulated to be identical by counsel involved.

Mr. Shapro: You may proceed on the assumption that they are because I agreed to it.

Q. (Continuing): Yes, and I also show you Objector's Exhibit No. 3. Now, Mr. Logan, I ask you if you are familiar with those statements?

A. I believe I have seen this one statement here.

The Referee: When you say—

The Witness: The balance sheet of October 1, 1952 and this comparative profit and loss statement from September '49 to September '52 and a comparative balance sheet for the corresponding period '49 to '52.

Q. Now, Mr. Logan, from these statements, are you able to form an opinion as to the adequacy of the capitalization of Leonard Plumbing & Heating Supply Company, Inc. at its inception?

Mr. Shapro: Before even that question is answered yes or no, your Honor, I would like the

(Testimony of William B. Logan.)

opportunity of examining the witness further on voir dire.

Examination on Voir Dire

Q. (By Mr. Shapro): Mr. Logan, in connection with your higher education at Lehigh University, to what extent, if any, did you study accounting or accounting methods?

A. I had two years of accounting there.

Q. Two years of accounting. Upper division or lower division? [78]

A. Through cost accounting.

Q. Will you answer my question? Upper division or lower division?

A. What do you mean by upper division or lower division?

Q. Lower division, as I understand, is freshman and sophomore — freshman and second year, and upper division is junior and senior.

A. First and second.

Q. First and second? A. Yes.

Q. Did you attend any other institutions of higher learning besides Lehigh University, sir?

A. No.

Q. And will you tell the Court please the nature of the accounting courses that you took in your first and second years at Lehigh?

A. That's going back a few years.

Q. By the way, how long, sir?

A. Oh, I finished there in '42.

(Testimony of William B. Logan.)

Q. You can't do it? You can't tell me the nature of the accounting? Your first year in accounting was elementary accounting, was it not?

A. That's going back a few years. It was, as I say, through cost accounting so it would cover going through general ledgers, setting up books and also setting up profit and loss statements and balance sheets.

Q. Then as I understand your testimony, during your career at Lehigh you took a lower division course or courses which included cost accounting, right? A. Right.

Q. Now, what accounting education have you had—I'm confining [79] it for the moment to education which you had since you graduated from Lehigh?

A. You mean formal or you mean personal training?

A. No, first formal. I am referring to education—formal—more than another. Have you worked in the field of accounting since your graduation?

A. Yes.

Q. Where and in what capacities?

A. Well, as far as a business analyst—

Q. Have you worked as an accountant for an accounting firm?

A. Well, may I ask as far as—there is a little difference between an accountant and a financial analyst.

Mr. Shapro: Yes, I realize there is, sir, and that is exactly why I am asking these questions.

(Testimony of William B. Logan.)

I would like to have the questions as asked answered, your Honor.

The Referee: Will you repeat that question?

(The last question was read by the Reporter.)

A. No.

Q. Have you worked in the office or accounting office doing accounting work for any business firm or corporation? A. No.

Q. What experience, if any, have you had in analyzing profit and loss statements other than as a business analyst?

A. Well, you asked me the questions before if I worked for an accounting firm. The answer was no, so as far as other experience beside my own as a business analyst, no.

Q. Now, you have been a business analyst for how many years, sir? [80] A. Since '47.

Q. Since '47. And you were employed, you stated, by a national business consulting firm. The name of that firm, sir, please?

A. George S. May Company.

Q. George S. May Company. And in what office?

A. San Francisco.

Q. And for how long?

A. A little better than two years.

Q. And what were the two years—what was the actual time?

A. '48 to '50—well, a little before then.

Q. And your business there was business engineer, I think you said. A. Uh-huh.

Q. And tell the Court, if you will please, just

(Testimony of William B. Logan.)

what function you performed during those two years for the George S. May Company?

A. Went to various businesses throughout the western states, a combination of analyzing, setting up corrective measures, various types of management programs, getting financial assistance, organizational measures, personnel matters, production matters—well, before you're through there, why you got familiar with all sorts of business problems that would come up.

Q. As a matter of fact, Mr. Logan, during the first eight to nine months of your employment with the George S. May Company you never went out in the field without a supervisor, did you?

A. The first six months. [81]

Q. You always went out—you went in the field with a supervisor.

A. With a supervisor, that's right.

Q. And did you after the first six months always go in the field visiting clients of the May Company without anyone with you?

A. Yes, I had an engineer or two or three engineers with me.

Q. Did you ever have an accountant with you?

A. Yes.

Q. As a matter of fact, you had an accountant with you on all phases of your work with the George S. May Company which involved the analysis or financial structure or recommendations concerning such a client, isn't that true?

A. Yes and no.

(Testimony of William B. Logan.)

Q. Well, when I say you had him with you, I mean you didn't have him with you; you consulted your accounting staff at May Company before you prepared your report and recommendations, didn't you?

A. It all depended upon the nature of the problem.

Q. My question assumes, Mr. Logan, that the problems involved were financial. By problems I don't mean financial insolvency; I mean that one or more of the things for which the May Company was retained by its client was to give advice along financial lines.

A. Yes.

Q. Financial rehabilitation which is in connection with capitalization.

A. That's right.

Q. And so forth. Now, it's true, is it not, Mr. Logan, that in all instances in which you operated on behalf of the May Company under such system, that before your recommendations were [82] transmitted to the client of the May Company, the advice or the assistance or both of an accountant or a member of the accounting staff of May Company was always involved?

A. Yes, Mr. Shapiro, yes.

Q. Shapro is the name, sir.

A. Shapro, thank you.

Mr. Shapro: At this time, if your Honor please, I would like to object to the question propounded to the witness upon the ground that no proper foundation is laid, that it calls for the opinion and conclusion of the witness upon matters upon which

(Testimony of William B. Logan.)

the witness is not an expert. In other words, the question that is asked him is whether or not from the documents that he has before him which are comparative balance sheets, profit and loss statements and an opening balance sheet of the corporation, whether he can form an opinion as to the adequacy of the capital.

Mr. Dole: Your Honor, before passing upon the question, permit me to ask one or two more questions.

The Referee: Sure.

Direct Examination

Q. (By Mr. Dole—Continued): Just as a business analyst, Mr. Logan, how many small businesses and corporations have you analyzed?

A. Approximately 150.

Q. And in analyzing such businesses, is it necessary that you study the opening financial statements or the financial statements of those corporations? [83]

A. Yes, we make a study of both the profit and loss and the financial statements.

Q. And in doing that it is necessary that you have a thorough knowledge of procedures in setting up that accounting statement and what the various figures represent?

A. Yes. May I clarify that a little bit?

Q. Yes.

A. There's a little difference from your accounting as far as basic accounting as to the proper

(Testimony of William B. Logan.)

analysis of a financial statement. I can refer you to one source, Roy Fouke, who is the executive vice-president of Dun & Bradstreet, I think the world's leading financial analyst, he has set out fourteen financial ratios and there is a book out, "A Practical Analysis of a Financial Statement"; it doesn't go into accounting methods but it goes into the explanation of, as far as the various ratios that affect a balance sheet and the proper interpretation and the proper analysis of those various ratios so from a practical sense of seeing the balance sheets and following companies through and recommending to various companies as far as serious trends and their financial picture, then I would say, yes, I am certainly familiar with this particular financial information.

Q. Then as I understand your answer, it's your business to accept the figures as prepared by the accountants. A. Yes.

Q. And as displayed upon the profit and loss statement and the balance sheet.

A. Correct. [84]

Q. And in accepting those figures to make your analysis. A. Correct.

Q. Upon them as well as other factors.

A. (There was no answer.)

The Referee: He may answer. Overruled.

Mr. Dole: Go back to the question.

Q. The original question, I believe, Mr. Logan, was: From these statements are you able to form an opinion as to the adequacy of the capitalization

(Testimony of William B. Logan.)

of Leonard Plumbing & Heating Supply Company at its inception? A. I believe so.

Q. And as revealed in these statements, what would you say was generally the adequacy of the capitalization of that concern?

Mr. Shapro: May my objections to all this line of questioning go, as heretofore objected and stipulated to with respect to the line of questions asked of the witness Heimbucher?

Mr. Dole: That's agreeable.

The Referee: And with the same understanding that if there is an additional objection you will make it.

Mr. Crews: That would apply to Ambrose also.

The Referee: Very well. When Mr. Crews says he wants it to apply to Mr. Ambrose, he wants it understood that he and Mr. Chew have an objection along the same line as Mr. Shapro.

Q. As revealed in these statements, Mr. Logan, what would you say was the actual usable amount of capital available to [85] Leonard Plumbing & Heating Supply Company?

A. The usable working capital would be consisting of the capital stock. Now, from the accounting standpoint, your notes payable as far as the stockholders was strictly a balance sheet item; it was not usable working capital. From actual, however, a standpoint that assets had been transferred into the corporation from the partnership, those assets would, of course, be usable. From the standpoint of the capitalization of the company, the

(Testimony of William B. Logan.)

\$6,000.00, that, from a strictly balance sheet item would be all the capital, the key worth of the operation.

Q. Now, considering the size of this operation, Mr. Logan, would you consider the \$6,000.00 an adequate capitalization?

A. Definitely not. In 1952, that same year, of about 124 companies in this particular line, the average ratio of turnover of net worth of capital to sales ranged between three and five times. On this basis here, on \$6,000.00, with a sales of approximately \$400,000.00 it would have better than 60, 65-time turnover which certainly is quite a contrast from a three to five-time turnover.

Q. Is a sixty-times turnover feasible at all?

A. Impossible strictly from the capitalization standpoint.

Q. I see. In converting from a partnership to a corporation as this organization has, Mr. Logan, has normal business procedure been followed with respect to the treatment of capital and investment accounts?

Mr. Shapro: I object to the question as calling [86] for the opinion and conclusion of the witness.

The Referee: Sustained.

Q. From these financial statements which you have in your lap, Mr. Logan, did Leonard Plumbing & Heating Supply Company have a reasonable hope of financial success?

Mr. Shapro: Same objection, if your Honor

(Testimony of William B. Logan.)

please, and it also calls for the conjecture of the witness.

The Referee: Same ruling.

Mr. Dole: Your Honor, these are principally in substance the same questions as were asked Mr. Heimbucher.

The Referee: And you may proceed on the same basis. In other words, so the record will be straight.

Mr. Shapro: In other words, the objections were sustained but the Court allowed the evidence to go in on the basis that he would not consider it.

The Referee: You may continue with your examination, Mr. Dole.

Mr. Dole: Your Honor, rather than go through an offer of proof again as I have before, is it agreeable with the Court that the offer of proof that I made on behalf of Mr. Heimbucher can be made here?

Mr. Shapro: Deemed made as to this witness. Yes, certainly.

The Referee: And satisfactory to the Court.

Mr. Crews: Satisfactory to counsel on both sides.

Mr. Dole: Now, can I repeat the question? [87]

Q. Now, I'll repeat the two questions I just propounded to you, Mr. Logan. In converting from a partnership to a corporation, has normal business procedure been followed with respect to the treatment of capital and investment accounts? You understand my question?

A. Yes. The answer to your question would be that normal procedure has not been followed, no.

(Testimony of William B. Logan.)

Q. In what respect has it not been followed?

A. As far as the capitalization of the partner's assets go into a capital account—going into a notes payable as a liability. From the standpoint of similar experiences in talking to companies who may have been in the same position, it has always been our recommendation to never attempt to do that because you would have creditors' objections, number one. Again—

Mr. Shapro: Your Honor, with due respect to your Honor and your desire to have the record have an answer I move to strike out the answer of this witness on the ground it's not responsive to the question.

The Referee: Sustained.

Q. You may continue your answer. Do you recall the question that I asked—the specific question, Mr. Logan?

A. As far as the adequacy of the capital in transferring from a partnership to a corporation.

Q. Well, the original question was in converting from a partnership to a corporation has normal business procedure been [87(a)] followed with respect to the treatment of capital and investment accounts?

A. And I believe I said no to that.

Q. You answered no. A. Yes.

Q. What were the deviations specifically that you observed in the treatment of those accounts?

A. The transferring of the partner's capital accounts into the corporation as a notes payable or

(Testimony of William B. Logan.)

as a liability rather than transferring all or most of the amount and the capital stock.

Q. I see. Had all of the amount of the partner's investments in the partnership been capitalized in the corporation as a partner or in the stock would that have made adequate capital for the corporation considering the corporation?

A. It would have been closer to it.

Q. Closer to it. A. Yes.

Q. Do you have an opinion as to whether or not it would have been sufficient?

Mr. Shapro: Not in three to five times.

The Referee: That may stay in.

Mr. Shapro: Yes, your Honor.

A. The answer to that would be, I believe, that it would have been adequate providing that some of the operations—the operating phase had been improved upon.

Q. I see. And in your opinion then, Mr. Logan, based upon these records, would you say that this was a well-managed concern [87(b)] from the point of view of your specialty?

Mr. Shapro: I object to the question on the grounds it is incompetent, irrelevant and immaterial, calls for the opinion and conclusion of the witness. That's the very issue that your Honor is going to be called upon here to pass on and furthermore there is no foundation laid because the witness is basing—could base his answer only upon the accounts that he has before him.

(Testimony of William B. Logan.)

Mr. Dole: The issue is the order of payment of these debts, Mr. Shapro.

The Referee: I'll sustain the objection without prejudice to Mr. Dole asking some other questions. You are asking him whether or not it's a well-managed—it was a well-managed corporation?

Mr. Dole: Yes.

The Referee: Lot of things to take into consideration.

Mr. Dole: Yes, that's very true. I am referring now to his specialty as business analyst.

Mr. Shapro: Well, if your Honor please, certainly a business analyst goes into more than a balance sheet and a profit and loss statement before he reaches a conclusion.

The Referee: Still sustained.

Mr. Dole: I have no further questions.

Mr. Shapro: I have no questions of this witness.

Mr. Chew: I have no further questions either.

Mr. Dole: I would like to call Mr. John Curran.

JOHN S. CURRAN

called as a witness on behalf of the Objecting Trustee, being first duly sworn by the Referee, testified as follows:

The Referee: And your business or occupation, Mr. Curran?

The Witness: Now, as one of the associates of W. B. Logan & Company. I am retired vice-president of the Anglo California National Bank, the head office.

Direct Examination

Q. (By Mr. Dole): Mr. Curran, you have just stated that you are now associated with William B. Logan & Associates. How long have you been associated with them, sir?

A. Oh, I would say over the last three or four years.

Q. And in what capacity are you associated?

A. As an analyst.

Q. Prior to that you indicated that you were associated with the Anglo California National Bank.

A. That's right.

Q. How long had you been with the bank?

A. The Anglo Bank?

Q. Yes.

A. I joined it in 1917. I was previously with another bank in 1907. [89]

Q. And at the time you retired from the bank, what was your position, sir?

A. Executive vice-president.

Q. In what department or in what capacity?

A. Well, I am in the commercial end—general

(Testimony of John S. Curran.)

—I had other departments under me—the general department as well as the general commercial.

Q. In your experience in the bank and serving in your capacity as vice-president, did you have occasion to pass upon the adequacy of the capitalization of very small corporations? A. Yes.

Q. And in doing that, did you study the opening balance sheets, the profit and loss statement and the balance sheet of such businesses?

A. Yes.

Q. And for what purpose did you have to make those studies in your banking business?

A. For the purpose of whether or not they were entitled to any credit by the bank.

Q. Throughout your association with the bank, how many such businesses did you inspect?

A. I guess in all those years you would give statements because not that you personally loan on that particular one but it was our practice in the bank as executive officer to analyze and have the results of all of the statements that were passed upon where loans were made to them.

Q. Based upon your experience with the bank, do you consider yourself familiar with the problems involving the capital requirements of small businesses? A. Yes. [90]

Q. Particularly from a lending standpoint. And you consider yourself able on inspecting the financial statements of a new corporation to form an opinion as to the adequacy of the capital of that concern? A. Yes.

(Testimony of John S. Curran.)

Q. Mr. Curran, I hand you these statements that Mr. Logan has just inspected and that Mr. Heim-bucher has just inspected such statements being Trustee's Exhibit No. 3, the opening balance sheet of Leonard Plumbing & Heating Supply Company, Inc. and Claimant's Exhibit No. 2 being the comparative balance sheet of Leonard Plumbing & Heating Supply Company for the years '49, '50, '51, '52 and comparative profit and loss statement for Leonard Plumbing & Heating Supply Company for the same years and I also hand you the original work sheet of Mr. Laborde the accountant who prepared these which it is stipulated is identical or reflects the same material as the exhibit just referred to. I ask, Mr. Curran, have you ever seen those statements before? A. Yes.

Q. And you have inspected them and are familiar with them? A. Fairly.

Q. From these statements then, Mr. Curran, are you able to form an opinion as to the adequacy of the capitalization of Leonard Plumbing & Heating Supply Company at its inception?

The Referee: Mr. Curran, before you answer—

Mr. Shapro: I would like to ask Mr. Curran a question or two on voir dire, if I may, your Honor.

The Referee: You may. [91]

Voir Dire Examination by Mr. Shapro

Q. Mr. Curran, when did you retire from the Anglo? A. At the end of 1950.

(Testimony of John S. Curran.)

The Referee: And the answer will be either yes or no.

A. Yes.

Q. Would you state your opinion?

Mr. Shapro: May my same line of objection go to the testimony of this witness as has gone to the testimony of the preceding two witnesses throughout? May it be so understood?

The Referee: And the same with the claim of Mr. Ambrose.

Q. Will you state your opinion on that question?

A. Yes, my opinion is that looking at this statement here that it is inadequate.

Q. Do you have an opinion as revealed upon those statements as to the actual amount of usable capital to make available for that concern?

A. Well, they have, from a standpoint here—analysis—they haven't any working capital, which was explained before. Because of the fact that it is shown here that their current liabilities exceed their current assets. So, therefore, there isn't any working capital left for the corporation to work on.

Q. I see. Mr. Curran, in converting from a partnership to a corporation as this concern has done, has normal business procedure been followed with respect to the treatment of capital and investment accounts?

Mr. Shapro: To that question I add the specific objection that it calls for the opinion and conclusion of the witness.

(Testimony of John S. Curran.)

The Referee: Sustained. And may the same stipulation as previously——

Mr. Shapro: Yes, sir.

The Referee: And the witness may answer for the record. But the objection is sustained.

A. Would you ask the question again?

Q. In converting from partnership to corporation, has normal business procedure been followed with respect to converting the partner's investment accounts to the corporation investment and loan accounts? A. They haven't followed that.

Q. What is the normal business procedure?

A. I would say it is natural, unless you are going from a partnership into a corporation, that you would naturally transfer all of the capital invested in the partnership into a corporation judging of the fact that it was necessary to have that amount in the partnership, certainly it is such they would need that amount of money in the corporation and further they certainly wouldn't take, if there were loans in there, and put them in as a liability. Of course, in that procedure, they are naturally placing [95] themselves in the same position as their creditors and I would think and it is my humble opinion that apparently they didn't have enough confidence in the corporation to put it in as a capital——

Mr. Shapro: I move to strike out the answer of the witness upon the ground that it is not responsive to the question and it represents his conclusions.

The Witness: That was only an opinion.

(Testimony of John S. Curran.)

The Referee: The opinion may go out.

Q. Then I will ask the question—if I ask the question, what were the deviations from normal procedure in setting up a new corporation such as this has been set up, would your answer be substantially the same as you have just given?

A. That's right.

Q. And if I also ask the question if you have an opinion as to the reasons for these deviations from good business procedure, would you give me substantially the same answer as you gave me before? A. Certainly.

Q. On the financial pictures indicated on these statements which you have inspected, Mr. Curran, do you believe that Leonard Plumbing & Heating Supply Company had a reasonable chance of success?

Mr. Shapro: I object to that on the ground it is incompetent, irrelevant and immaterial, calls for the opinion and conclusion of the witness and conjecture.

The Referee: Sustained. [96]

Mr. Dole: Is the answer subject to the same reservations?

The Referee: Yes.

Mr. Dole: You may answer that.

A. I would say it would be very problematical.

Mr. Dole: I have no further questions.

Mr. Shapro: I have no questions of this witness.

Mr. Crews: No questions.

(Discussion off the record.)

(An adjournment was taken until February 13, 1956 at 10:00 o'clock a.m.) [97]

February 13, 1956—10:00 A.M.

The Referee: Same appearances. And the objecting trustee is still putting on his case.

Mr. Dole: Yes. I would like to call Mr. Laborde.

The Referee: Mr. Laborde.

Mr. Dole: And this examination will be under Section 21(j).

ROBERT H. LABORDE, JR.

called as a witness by the Objecting Trustee under Section 21(j) of the Bankruptcy Act, being first duly sworn by the Referee, testified as follows:

The Referee: Your full name, Mr. Laborde?

The Witness: Robert H. Laborde, Jr.

The Referee: And your occupation?

The Witness: I'm a CPA.

The Referee: In business for yourself or employed by someone else?

The Witness: In business for myself.

The Referee: Mr. Dole?

Examination

Q. (By Mr. Dole): Mr. Laborde, of whom does your firm consist?

A. At the present time I'm the present owner.

Q. And what is your business address?

A. It's Fischer & Laborde, the Bank of America Building in Berkeley. [98]

Q. And Mr. Fischer has since——

A. He has passed away.

Q. He has passed away. You represent, I under-

(Testimony of Robert H. Laborde, Jr.)

stand, the firm of Leonard Plumbing & Heating Supply Company, Incorporated or you did until its dissolution?

A. Yes, we did. We took care of their books and so forth.

Q. I see. When did you first commence taking care of their books?

A. We began with them since the day they opened business.

Q. And when you say since the day they opened business, are you referring to opening business as a partnership or a corporation?

A. As a partnership.

Q. As a partnership. Do you remember approximately when that was?

A. It was around September of '48.

Q. I see. And in connection with the partnership business when did you first start representing them — what was the nature of your duties with them?

A. My particular duties?

Q. Yes.

A. Well, the office where I worked — at that time I was working for Brethauer & Fischer — they were caring for the books. We maintained a general ledger for awhile. Then we made up monthly statements — manual statements and income tax returns.

Q. I see. And while you were with Brethauer & Fischer, is that correct?

A. Yes.

Q. Were you assigned to Leonard Plumbing & Heating Supply Company? [99]

(Testimony of Robert H. Laborde, Jr.)

A. No, not as such. I worked on Mr. Fazio's books. Cared for the account and I supervised.

Q. Oh, I see. So you're familiar with his books then from the inception of the business?

A. Yes.

Q. What type of records did you have access to?

A. At Leonard?

Q. At that time.

A. Well, all of their books and records.

Q. All of their books and records. I see. I think I asked you when they were first organized. I didn't get your answer, sir.

A. I think it was sometime around September of '48.

Q. It does not matter; you don't have to specifically——

A. Yes, it was around September of '48.

Q. Who were the original partners?

A. The original partners were Bert Leonard and Laurence Ambrose and Joseph Fazio.

Q. And they are the same people who are the shareholders of the corporation, is that correct?

A. Yes.

Q. So the same people have carried through in the same business——

A. Yes.

Q. (Continuing): ——from the inception of the partnership to the time of dissolution. A. Yes.

Q. Which partner, or did he contact you first with reference to keeping the partnership books?

A. None of them contacted me particularly. I think they probably talked to Mr. Fischer.

(Testimony of Robert H. Laborde, Jr.)

Q. I see. And then the matter was turned over to you. A. Yes.

Q. With regard to keeping the partnership books, were you given any sort of agreement such as Articles of Partnership or an agreement with respect to partnership? A. No, we didn't—

Q. As a basis for your work?

A. No, we didn't have any articles of partnership in writing.

Q. In other words, your talks were strictly oral, is that correct? A. Yes.

Q. What were the original investments of the three partners in the business?

A. Mr. Fazio invested \$39,606.40; Mr. Ambrose invested \$4,000.00 and Mr. Bert Leonard invested twelve hundred.

Mr. Walsh: Mr. who?

The Witness: Bert Leonard.

Q. In what form did those investments take? Were they in the form of assets or were they in the form of cash?

A. The investment by Mr. Fazio was in the form of an inventory contribution. The other two by cash.

Q. And from what document are you reading from?

A. This is it. (The witness handed the paper to Mr. Dole.) I think that's the pencilled copy of the typed copy.

Q. And what do you call this from which you are reading? [101]

(Testimony of Robert H. Laborde, Jr.)

A. These are some notes of the summary of the partnership net worth transaction from the time they started business until September 30, 1952 when the corporation was formed.

Q. Did you prepare that summary, Mr. Laborde? A. Yes.

Mr. Dole: Can we mark that for identification please?

The Referee: Sure.

Mr. Dole: I don't think that's an exhibit.

Mr. Shapro: No, it's not an exhibit.

The Referee: Objector's No. 4 for identification.

(The paper referred to was received for identification by the Referee and marked "Objector's Exhibit No. 4 for Identification.")

Mr. Walsh: What is the date of that?

The Referee: It doesn't have a date.

Mr. Shapro: It's not dated.

The Witness: It runs from 1948 to September 30, 1952.

Q. Were there any subsequent contributions towards capital by any of the partners after the original contribution?

A. No, except for the one thing, of course, the inventory contribution by Mr. Fazio was done on two different times—one in very late '48 and one in very early '49.

Q. This figure which you have just given of thirty-nine thousand some odd dollars, does that include both the service shops? A. Yes. [102]

Q. So you consider those the total contributions.

A. Yes.

(Testimony of Robert H. Laborde, Jr.)

Q. Were you given instructions as to profit-sharing arrangements of the partners?

A. Yes.

Q. And what were your instructions?

A. Mr. Leonard was to receive a salary. The profit was to be split equally between the three after Leonard's salary.

Q. And from whom did you receive those instructions, if you recall?

A. I don't recall right now exactly.

Q. I know it was a long time ago. You say only Mr. Leonard was to receive a salary.

A. Yes.

Q. And was there a specific arrangement as to salary? Did it vary from time to time?

A. The amount varied over a period of time.

Q. Was there an arrangement with respect to a drawing account by any of the partners—a written drawing account?

A. Not that I recall. I never saw anything in writing and I never heard anyone discuss it orally as far as I know.

Q. In other words then, I gather that such drawings as there were were made for the partners and then you were informed of the amounts made for them so that you could record it in the partnership books.

A. Yes, that's right.

Q. Does this summary which you have in your hand reflect the drawings of each partner?

A. Yes.

Q. From the fiscal year then October '48 [103] to September 30, '49 there was a drawing only by the partner Leonard, is that correct?

(Testimony of Robert H. Laborde, Jr.)

A. Yes. That drawing is in excess of his salary.

Q. I see. And the same would be for the following fiscal year '49 to '50. A. Yes.

Q. Drawing there. And then in the fiscal year '50 to '51 there was a drawing then by all three partners but in varying amounts, is that correct?

A. Yes.

Q. As you have indicated it. Now, for the fiscal year '51 to '52 you have an item marked "transfers" I believe on that summary. Would you explain that to me, please?

A. Well, the transfers that took place there were two. There was a \$2,000 credit transferred from Mr. Fazio's account to Mr. Ambrose's account and then there was a \$3,060.11 credit for Mr. Fazio and a \$3,060.10 credit for Mr. Ambrose. Mr. Fazio was \$3,060.11 and Mr. Ambrose was \$3,060.10 which totals \$6,120.21 which was given to Mr. Leonard to his credit.

Q. Do you know what the basis of those transfers was?

A. Yes, they were personal notes executed by Mr. Leonard to each of the other two for those amounts.

Q. I see. The transfer is a plus figure for—Oh, no, I beg your pardon. In other words, both Mr. Fazio and Mr. Ambrose transferred to Mr. Leonard's account. A. Yes.

Q. So you have debited their accounts—rather, the accounts of Fazio and Ambrose are credited the account of Leonard. A. Yes. [104]

(Testimony of Robert H. Laborde, Jr.)

Q. And the fiscal year '51 to '52 there were cash withdrawals by all three partners, is that correct?

A. Yes.

Q. And those cash withdrawals totalled \$3,500.00 for Fazio, \$6,019.00 for Ambrose and \$5,468.00 for Leonard, is that correct? A. Yes.

Q. Now, that was the last year that the company existed as a partnership, isn't that correct?

A. That's correct.

Q. And in September of that year or October 1 of that year they incorporated. A. Right.

Q. And that also coincidentally I have indicated on the profit and loss statement, I believe, which is Mr. Fazio's Exhibit No. 2, that was the same year in which they lost \$22,000.00, is that correct?

A. Yes, the fiscal year ended September 30, 1952, they lost \$22,500.00.

Mr. Dole: Your Honor, could Objector's Exhibit No. 4 for Identification be introduced into the record?

The Referee: Do you have it, Mr. Laborde? Objector's No. 4 for Identification becomes No. 4 in evidence.

Q. Prior to the incorporation of Leonard Plumbing & Heating Supply Company, while they were still a partnership, were there any notes given to any of the individual partners by the partnership itself?

A. There was—very late September 1952 there were notes given by the partnership to Mr. Fazio and Mr. Ambrose. [105]

(Testimony of Robert H. Laborde, Jr.)

Mr. Dole: Are those in evidence? Do you have copies of those? I'm not sure whether they are or not.

Mr. Shapro: I'm not sure, either. Yes, the \$4,400.00 one of Fazio is. Mr. Ambrose, rather.

Mr. Dole: That's Objector's No. 5, is that correct?

Mr. Shapro: This is Plaintiff's No. 4.

Mr. Dole: That's in evidence.

Mr. Shapro: That's No. 4.

Q. Mr. Laborde, would you recognize either of those notes if I gave them to you now?

A. Yes, I think I would.

Q. I give you this document, I believe this is in evidence already, and ask if you recognize that?

A. Yes.

Q. And which note is that?

A. That is the note executed by the partnership to Mr. Ambrose.

Q. And the date of that note is September 15.

A. Yes.

Q. 1952. A. That's correct.

Q. That was some two weeks before the incorporation, is that correct? A. That's correct.

Q. What was the consideration given for that note, Mr. Laborde?

A. That is a—in other words, his capital account, I think at that time, would have been \$6,451.17 and this separated his capital account from—broke it up—Two Thousand capital and \$4,451.17 note payable. [106]

(Testimony of Robert H. Laborde, Jr.)

Q. May I see the note? Has he transferred any cash to the partnership for this note then?

A. Not at that time.

Q. Or at any time?

A. Well, he actually had more of an investment than Leonard who was the lowest member of the group so I mean it depends on how he looked at it. But at that particular time, he didn't put any money in.

Q. Now, referring to your summary of net worth, is that what you refer to—the way in which you refer to this Objector's No. 4?

A. Yes, that would be a summary of the partnership.

Q. Your figure here for Mr. Ambrose on 9-30-52, September 30, '52 indicates his capital account as having in it \$6,451.17. A. Yes.

Q. Actually that wouldn't be correct then, would it?

A. Well, broken down between—if you look right below that it was set up as Two Thousand capital for the ending balance sheet of the partnership; it was set up as Two Thousand capital and partners alone \$4,451.17.

Q. In other words, all he was doing was transferring the—his capital account into a debt account as evidenced by this note, is that correct?

A. Yes, that's correct.

Q. That's just an accounting procedure, just changing the nature of the amount of the capital obligation.

(Testimony of Robert H. Laborde, Jr.)

A. The accounting just reflects what they intended to do [107] at that time.

Q. I see. Now, I show you this note bearing the amount to Mr. Fazio and ask you if you recognize that?
A. Yes.

Q. And that is in the amount of Forty-one Thousand—
A. 169.61.

Q. (Continuing): —169.61, and again that's a similar transaction.
A. Yes.

Q. Did you prepare either of these notes?

A. Mr. Fischer did as I recall it.

Q. Again, no cash was given in return as consideration for this note.
A. Not at that time.

Q. All they did was deduct the amount in their capital accounts.
A. Yes.

Q. And transfer it into a loan account or a debt account, is that correct?
A. That's right.

Q. Did you ever have any discussions with either Mr. Fazio or Mr. Ambrose or as far as that goes with Mr. Leonard with reference to the creation of these notes?

A. I think I probably did at the time. I don't recall exactly.

Q. You don't recall what that discussion was?

A. I don't recall the exact terminology. I recall we were to break the things down between so much of an investment and so much for loan.

Q. Did you know at that time that the partnership intended to organize as a corporation?

A. Very definitely so.

Q. Did you have a discussion with either of the

(Testimony of Robert H. Laborde, Jr.)

three [108] partners with respect to the changing of the method of the accounting by transferring these sums from a capital account to a time account?

A. Well, the whole thing was done at one time. This transfer would bring Leonard up to a debit balance in his capital account and the setting up of a \$2,000.00 figure as capital and setting up the loans all done all at the same time more or less. It was all set up from the viewpoint that the business was going to be sold or transferred over to the corporation with the \$6,000.00 capital stock.

Q. Did you have discussions with the three partners with respect to that transaction?

A. You mean setting up the loan?

Q. Yes. A. Yes.

Q. And was that all done — that was all done then, as I understand your testimony, in connection with the prospective incorporation. A. Yes.

Q. Did they ever explain to you their reasons for doing it in this manner?

A. Well, we were the ones who decided the procedure and we discussed it with them.

Q. And what was your reason for doing it that way?

A. Well, the fact that the business was to be transferred to the corporation for the \$6,000.00 capital stock and the balance to be set up as a loan payable.

Q. Did you consider the fact that that very same year that [109] the corporation had lost \$22,000.00?

(Testimony of Robert H. Laborde, Jr.)

Did you discuss that fact with them and the effect it might have upon the financing of the business?

Mr. Crews: Just a second, I object to that question on the ground he is using the term corporation loosely and if he had placed it with the partnership, the partnership hasn't been—the corporation hasn't been formed yet.

(The last question was read by the Reporter.)

Mr. Dole: Partnership.

The Referee: Mr. Crews' comment is well taken. Would you have any objection to the question if partnership were substituted?

Mr. Crews: No.

A. The determination of exactly how much money they lost wasn't made until after September 30 so I didn't know it was Twenty-two Thousand until probably sometime in November—late October. But I did discuss the fact that it was losing money with Mr. Fazio.

Q. And do you remember the specific conversation that took place between you and the several partners with respect to that subject?

A. Oh, I can recall talking to Mr. Fazio over a period of time on numerous occasions about limits and he suggested that the business be incorporated.

Q. Did you originally suggest to them that the business be [110] incorporated?

A. Yes, I originally suggested to Mr. Fazio the business be incorporated.

Q. And when did you first make that suggestion to him?

(Testimony of Robert H. Laborde, Jr.)

A. About the fall, I would guess, somewhere about '51.

Q. What was your reason for making that suggestion?

A. Well, the business was primarily financed by Mr. Fazio's investment. Leonard was drawing the money out—I mean wasn't allowing anything to accumulate in the business. Mr. Fazio was active in the business. Mr. Ambrose was active in Mr. Fazio's business and only devoted part-time to Leonard's; it wasn't too good of a working relationship. The liabilities on the business as a partnership were pretty heavy. So I simply suggested that they incorporate.

Q. But what was the reason? Why did you think then that the corporation was necessary—desirable under those circumstances?

A. Well, it all depends on how you look at it. When I have a client who, for example, is in the high tax brackets as an individual, when a majority of the income that is made goes out for taxes, he is not active in the business, he doesn't have too much of a personal interest in the business, you have a lot of conditions that would call for having a corporation.

Q. Which of your clients was in the high tax bracket? A. Mr. Fazio.

Q. So it was in order to protect his personal interest that [111] you suggested the incorporation.

A. Yes.

(Testimony of Robert H. Laborde, Jr.)

Q. At the time you say you suggested this incorporation in the fall of 1952, is that correct?

A. Fall of '51.

Mr. Shapro: '51.

Q. And, of course, it was accomplished in the fall of '52. A. Yes.

Q. Would you have suggested it to Mr. Fazio had you realized that in the fiscal year '51-'52 the partnership was going to lose \$22,000.00?

A. If I'd have been able to look forward, that would have been that much more reason for having incorporated.

Q. You realized, of course, at this time that the individual partners were individually responsible for the debts. A. Yes.

Q. And you had that thought in mind.

A. That's correct.

Q. So then as revealed in the comparative balance sheet for the partnership through all those years until the date of the incorporation and the profit and loss statement, those are already in evidence, are they not?

Mr. Shapro: Yes, they are.

Mr. Dole: I believe they are. As Mr. Fazio's Exhibit No. 2, is that correct? Are both of them the same exhibit?

Mr. Shapro: Yes, the balance sheet and the P & L comparative, Claimant's No. 2. [112]

The Referee: Off the record, Mr. Dole.

(Discussion off the record.)

Mr. Dole: Now, that is the original note executed

(Testimony of Robert H. Laborde, Jr.)

September 15, 1952 by the partnership to Mr. Fazio—rather, it would be by the three partners individually to Mr. Fazio. I will introduce this in evidence now as trustee's or objector's exhibit next in order.

The Referee: No. 5.

(The document referred to was received in evidence by the Referee and marked "Objecting Trustee's Exhibit No. 5.")

Mr. Dole: Are the subsequent notes in evidence, Mr. Shapro?

Mr. Shapro: The subsequent note of Mr. Ambrose's is in evidence. The note of Mr. Fazio, the corporation note, the original is attached to his claim. It is in evidence as such.

(Discussion off the record.)

Q. Mr. Laborde, do you know whether at the time of the formation of the corporation, a dissolution of partnership was placed on file—a notice of dissolution of partnership?

A. No, I don't know.

Q. You don't know that at all. Do you know whether any such notice was given to creditors with respect to the change of the form of the business from partnership to corporation?

A. No, I don't. [113]

Q. Now, Mr. Laborde, referring now to Claimant Fazio's Exhibit No. 2 and the aspect that I am referring to is the comparative balance sheet—I think the same information would be on Trustee's Exhibit 3, the opening balance sheet—I notice that the September 30, 1952, that is the closing statement for the

(Testimony of Robert H. Laborde, Jr.)

partnership, you have two separate accounts here, one being notes payable and the other liabilities—loans from partners. Actually, that's a note payable account too, isn't it?

A. Would you mind repeating that question?

Q. Yes. You have two items. I'm referring to the liability side now of the balance sheet, notes payable \$59,000.00.

A. Oh, the notes payable \$59,000.00 to the American Trust.

Q. Oh, I see. When was that obligation first incurred?

A. Oh, they ran obligations to the American Trust all along for quite a long period of time.

Q. Was the \$59,000.00 evidenced by a single note?

A. No. It might be several things. That included a—let's see, there was a \$9,000.00 unsecured note and then \$50,000.00 against the accounts receivable.

Q. Oh, I see. When was the \$50,000.00 obligation originally incurred?

A. Oh, that was a running thing. They just went down and as they collected money on their accounts receivable, they gave them to the bank and if they sold merchandise they just went down and borrowed more money against it.

Q. So it was a fluctuating account. [114]

A. Fluctuating thing.

Q. You have it as a nice round figure for September 30, 1952, for \$59,000.00. A. Yes.

Q. Is that a note for \$59,000.00?

(Testimony of Robert H. Laborde, Jr.)

A. It would be several notes. That would have——

Q. You have told us already that there was a separate note for \$9,000.00 unsecured.

A. I don't recall whether they were signing actual notes financing against their accounts receivable or not but I presume they would have. Later they were. But it was run rather informally though with the American Trust.

(Discussion off the record.)

Mr. Walsh: Claim of the American Trust Company, claim No. 135 was filed June 29, 1955, \$20,-662.99 plus interest.

The Referee: Did it make any allusion with reference to the accounts receivable, did you notice?

Mr. Walsh: No.

The Referee: Did it just say unsecured claim?

Mr. Walsh: No, I have the claim file over in my office, but I remember it.

The Referee: You got that information from what—docket sheet?

Mr. Walsh: Docket, yes.

Q. At any rate, Mr. Laborde, on September 30, 1952 the last day of the partnership there was owing to American Trust Company [115] \$59,000.00.

A. That's correct.

Q. And those funds had been advanced to Leonard Plumbing & Heating Supply Company from time to time while it was a partnership.

A. Yes.

Q. Years preceding. At the time of the incorpo-

(Testimony of Robert H. Laborde, Jr.)

ration, was a new note executed to American Trust Company by the corporation?

A. I presume it was. I never did actually see it; I presume it was because the bank knew that it was being incorporated.

Q. I see. And you never saw that note at all.

A. No.

Q. You would also assume that it would be in the amount of \$59,000.00. A. Yes.

Q. Was that entire amount of \$59,000.00 paid back to the American Trust Company during the term of the corporation? A. Yes.

Q. The full \$59,000.00 was paid back.

A. Yes.

Q. May I see your accounts indicating payments to American Trust Company during the period of the corporation?

A. This is the only thing I have. It's dated September 30, 1953. "Notes renewed monthly" according to the notes of the CPA that did the examination.

Q. Do you have anything that indicates how much money was paid to the American Trust Company from October 1, 1952 to the time that the corporation discontinued business?

A. Oh, well, they were giving them practically all the cash that was coming in from sales so it would have been a pretty sizable figure but I mean, I don't have anything—— [116]

Mr. Shapro: Won't it——

A. (Continuing): No, that would be in the gen-

(Testimony of Robert H. Laborde, Jr.)

eral ledger. I would guess it would be several hundred thousand dollars over a period of time that would be paid in the following fiscal year.

Mr. Shapro: The general ledger—the one you had here the first time.

Mr. Walsh: Yes, I left it, do you remember?

Mr. Shapro: Yes, you did leave it but that isn't it.

Mr. Dole: No, it's a small one.

(Discussion off the record.)

Mr. Shapro: Maybe we can agree that whenever it's located it can go into evidence.

Mr. Dole: Yes.

(Discussion off the record.)

Q. Mr. Laborde, in other words, new notes were executed from time to time by the American Trust Company.

A. Well, they would pay against these notes and then go out and get more money against the receivables.

Q. And the American Trust Company at the time continued putting money into the corporation and the corporation continued——

A. That's right, they would pay on the old and borrow new. It was just a shuffle all the time.

Q. Mr. Laborde, I understand that the corporation actually came into existence October 1 for your purposes—accounting [117] purposes—1952.

A. Yes.

Q. And that an application was subsequently made to the Corporation Commissioner for a per-

(Testimony of Robert H. Laborde, Jr.)

mit to issue securities and the permit was received from the Corporation Commissioner. That's in evidence.

Mr. Shapro: It's Objector's No. 2.

Mr. Dole: That's Objector's No. 2 in evidence.

May I see the permit please?

Mr. Shapro: Surely.

Q. This permit, of course, requires under Paragraph W that the stock be held in escrow. Was there an offer to sell the partnership assets to the corporation made prior to the actual incorporation of the business?

A. The corporation having been formed on September 22, I don't know just exactly legally how that would follow when you would be transferring from a partnership to a corporation.

Mr. Shapro: I submit, if your Honor please, that the record is the best evidence. The minute book shows when the offer was made and how.

The Referee: Very well. Sustained.

Q. And the corporation was organized on the basis of 600 shares of capital stock, I believe that was no par value, and valued at Ten Dollars a share. Was the contribution of each shareholder his \$2,000.00, is that correct?

A. Yes, that's their contribution.

Q. Actually, there was no transfer of cash to the corporation. [118] However, it was just a transfer of the assets and liabilities of the business in return for the stock, is that correct?

Mr. Shapro: I submit, if your Honor please, that

(Testimony of Robert H. Laborde, Jr.)

the question assumes a fact not in evidence and is incompetent, irrelevant and immaterial because the permit does not call for cash; the permit doesn't call for the issuance of stock against cash.

Mr. Dole: I am not making that point.

The Referee: You just ask it.

Mr. Dole: I just ask it.

The Referee: Overruled.

A. They just simply transferred the partnership assets and liabilities based on this statement.

The Referee: When you say this statement—

The Witness: This statement here which is Claimant's No. 2, Assets and Liabilities as of September 30, 1952.

Q. I see. May I see Claimant's No. 2 please—the original? Trustee's No. 3, is that available?

The Referee: They're all available.

Q. (Continuing): Actually, this Trustee's No. 3 that I show you, Mr. Laborde, represents a state of affairs as of the time you transferred to the corporation, does it not? A. Yes.

Q. Was this balance sheet prepared with an unqualified opinion or qualified opinion?

A. It was unqualified. [119]

Q. Unqualified opinion.

A. Yes, the balance sheet as of September 30, 1952 of the partnership which is the same as the opening of October 31, 1952.

Q. Under the provisions of Title XVI of the Administrative Code, Section 58, to express an unqualified opinion, Mr. Laborde, you are required to

(Testimony of Robert H. Laborde, Jr.)

acquire by the application of generally accepted accounting principles and procedures sufficient information to warrant such an opinion. Did you do that? A. Yes.

Q. Did you have an appraisal of the inventory?

A. You mean outside appraisal?

Q. Yes.

A. That is not customary under the rules that you have just quoted.

Q. Just answer yes or no. A. No.

Q. Did you or any member of your firm check the inventory? A. Yes.

Q. And which member of your firm did that?

A. The man that was actually there on October 2, 3, 4, and 5 was a CPA who is no longer with us by the name of Jim Arding.

Q. Did you instruct him with regards to checking and inspecting that inventory at all?

A. Personally, no.

Q. What were your instructions to him with regard to the inventory?

A. He was to—normally, he would know what to do. I [120] mean, he is well qualified. He went down and checked the inventory procedures, test-checked physical quantities. After the inventory was all complete, he would have test-checked the unit prices, test-checked extensions and checked totals.

Q. Do you and your firm give an unqualified opinion then that the amount of inventory indicated on this balance sheet is correct?

(Testimony of Robert H. Laborde, Jr.)

A. Yes, based on an examination as to the inventory, we could have. We did——

Q. And one member of your firm made that examination.

A. Normally we would do that in the case of where someone was incorporating we would have to give an unqualified opinion.

Q. Did you do it in this case? A. Yes.

Q. You say normally you would. But you gave no particular instructions to your accountant. What did you tell him with respect to preparation of this balance sheet?

A. No, I mean he is very well qualified as I say. I just went down and told him to check the inventory.

Q. And he returned to you. And what did he tell you? What information did he give you with respect to that inventory?

A. Well, of course, his papers are all written up. These happen to be his work sheet. He made notes as to the work he had done and so forth.

Q. Do you have those notes? A. Yes.

Q. May I see them please?

A. (The witness handed the papers to Mr. Dole.)

Q. Whose writing is this, Mr. Laborde?

A. That's Mr. Arding's.

Q. When did Mr. Arding prepare these notes?

A. I presume during the course of when he was making up the statements and everything and at the time he was making these various checks. In other words, he probably wrote those notes up a week or

(Testimony of Robert H. Laborde, Jr.)

so after; when he was all through working on the inventory he probably wrote them out.

Q. When did you first see these notes?

A. As such?

Q. Yes.

A. Oh, I don't recall exactly. I was just going through all the working papers again getting ready to come up here and that was one of the items I was looking over. Those would be typical, you know, from an examination of that type.

Q. I notice that on this balance sheet which is noted as Objector's No. 3, that there is no opinion stated, either qualified or unqualified. Is that merely an oversight?

A. That's correct. No, you asked—that was prepared—I prepared that just after we had that examination when we were down in the other building, oh, six or eight months ago. You asked for the opening entries for the corporation. That's how you happened to get that one. I can't seem to find their September 30 partnership with an unqualified statement on it. But if it was prepared with the audit, there has been any qualification as such, it would have been noted on the bottom of our [122]work sheet that this was prepared with audit, or the other one particularly, the one September 30, 1952 this happens to be just a memorandum of the September 30, 1952 statement. There is one that you have my work sheet on that Arding prepared, I think you had here a moment ago, which showed comparative profit and loss statement and so forth. I mean, that

(Testimony of Robert H. Laborde, Jr.)

was typed—it was typed without any notations at all so I presume that this was prepared with a complete check; otherwise, it would have to be prepared without an audit or some sort of a qualification.

Mr. Dole: I have no further questions of Mr. Laborde.

Redirect Examination

Q. (By Mr. Shapro): Mr. Laborde—

The Referee: Mr. Shapro, so there will be no misunderstanding between all of the counsel for the claimants and counsel for the trustee, is your examination now going to be on the basis of the redirect?

Mr. Shapro: Yes. At this point, I will lead it if I may to redirect. I'll try to confine myself to that subject matter.

Q. Mr. Laborde, you gave to counsel for the trustee your reasons that prompted your suggestion of the incorporation of Leonard's, to your knowledge was there any intention on the part of any of the three partners to avoid the payment of any of the partnership indebtedness by the corporation?

A. No.

Q. As a matter of fact, Mr. Laborde, all of the partnership [123] indebtedness was subsequent to October 1, 1952 paid by the corporation.

Mr. Walsh: Just a minute, if your Honor please, we will object to that as the accounts are the best evidence. How could he know all of that?

The Referee: Do you think you could answer Mr. Shapro's question?

The Witness: Yes.

(Testimony of Robert H. Laborde, Jr.)

The Referee: You know that they were all paid.

The Witness: With the exception of the notes to the two partners.

Q. To the two partners. Now, Mr. Laborde, is it correct to say that the September 30, 1952 balance sheet and profit and loss statement was made after audit? A. Yes.

Q. And the audit was made by your firm.

A. Yes.

Q. In connection with the inventory, how was the inventory priced in that audit?

A. It was priced by Mr. Leonard or one of his employees. I think he priced it principally.

Q. And it was at cost or market, whichever was lower.

A. Yes, that's what he was supposed to do.

Q. When you testified on direct examination here that there was verification by your office of inventory pricing and extensions, did that include to your knowledge the verification of pricing as between cost or market, whichever was lower?

A. Yes, we were to take the invoices that would be on file [124] of the people that shipped the merchandise and he took those to establish the unit prices.

Q. Is the employment of an independent or outside appraiser customary in connection with the making of an audited return on inventory?

A. No, sir, it's not customary.

Q. How long have you been a certified public accountant, Mr. Laborde? A. Since 1948.

(Testimony of Robert H. Laborde, Jr.)

Q. And how long prior to that were you engaged in public accounting practices?

A. Four years.

Q. And your experience then is with the firm of Brethauer & Fischer, subsequently Fischer & Laborde.

A. Yes. I had some experience prior to the war in New Orleans.

Q. In New Orleans?

A. It was another CPA.

Q. Mr. Laborde, referring your attention to Objector's No. 4—just answer this question, if you will, yes or no—do you know what was done with the withdrawals by Mr. Ambrose for the fiscal year October 1, 1950 to September 30, 1951?

A. No.

Q. Do you know what was done with the withdrawals by Mr. Ambrose for the year October '51 to September 30, 1952?

A. Yes.

Q. Will you tell the court what that was?

Mr. Dole: I'm going to object to that as incompetent, irrelevant and immaterial; it has no application to the [125] issue before the court.

Mr. Shapro: Your Honor, counsel interrogated the witness with respect to the exhibit, to which same exhibit I am referring, and this particular question on the basis of—he leaves the inference in the air that Mr. Ambrose withdrew \$6,000.00. I want to show what the witness says happened to the money.

The Referee: He may answer.

(Testimony of Robert H. Laborde, Jr.)

The Witness: Would you mind repeating the question?

(The last question was read by the Reporter.)

A. Yes, we computed that withdrawal for him as to—on March 1, 1952, we had to file a 1951 income tax return. Mr. Ambrose wanted to know how much he was paying as a result of the inclusion of the partnership income in this '51 income tax return. That amounted to \$5,446.08 and the reason why we computed it at that time was so that he could draw the money from Leonard Plumbing Company.

Q. To pay his income taxes?

A. To pay his income taxes. Now, there was a prior computation that was made for him at somewhere along the line which I never participated in, which would be a result of his income taxes for the year 1950. This computation relative to the 1951 income tax was paid in that \$6,019.08 I did participate in myself.

Q. Do you know, Mr. Laborde, what was done with the \$3,500.00 that was withdrawn by Mr. Fazio in the 1951-52 year? A. That was— [126]

The Referee: Do you know?

The Witness: Yes.

Q. What was it?

A. It was the approximate amount I gave to him which his taxes were increased—personal income taxes were increased as a result of the inclusion of the Leonard Plumbing & Heating Company income in his individual tax return.

(Testimony of Robert H. Laborde, Jr.)

Q. And for what year was that individual income tax involved?

A. That would be the year 1950—yes, that would be the year 1950 because I never made any computation for the year '51 for him.

Mr. Shapro: No further redirect.

The Referee: Mr. Dole and Mr. Walsh, are you finished with Mr. Laborde, temporarily?

Mr. Dole: Objectors rest, your Honor.

The Referee: And that's the objector's case. Thank you, Mr. Laborde. The first witness for the claimants.

ROBERT H. LABORDE

called as a witness on behalf of the claimants, having been previously sworn by the Referee, testified as follows:

Direct Examination

Q. (By Mr. Shapro): Mr. Laborde, will you give to the Court at this time something of the nature of your experience in connection with businesses of this character—this character referring to that [127] of Leonard Plumbing & Heating and both as a partnership and as a corporation?

A. Well, you mean just what I did for the Leonard—

Q. No, what is your experience in connection with other businesses of similar character?

A. Well, this is the only plumbing supply house as such that I handled. I do have several other accounts that are in the hardware business and so on or trading businesses that are similar.

(Testimony of Robert H. Laborde.)

Q. And in connection with your work as a certified public accountant, have you from time to time been called upon to explain opinions as to the adequacy of working capital? A. Yes.

Q. And have you done so on numerous occasions? A. Yes.

Q. Were you similarly consulted by the Leonard group at or shortly prior to the incorporation of Leonard's? A. Yes.

Q. And on what did you—before I ask you what the opinion was—will you tell the Court upon what you based an opinion that you gave and which I am subsequently going to ask you to repeat here with respect to the adequacy of the working capital of this business immediately before and immediately subsequent to its incorporation?

Mr. Dole: Could I hear the question, please, your Honor? I'm going to object to that question as indefinite and confusing. I don't understand it.

The Referee: He is asking on what he based his opinion. That's all he is asking.

A. Well, by the conduct of the business and the knowledge actually participating with them and various things.

Q. In other words, your opinion was based upon your own knowledge of the business itself from its inception. A. Yes.

Q. And the contact that you had with that business was, as you described on direct examination when you were called by the trustee. A. Yes.

Q. Did you base your opinion on the same sub-

(Testimony of Robert H. Laborde.)

ject-matter that has been introduced in evidence here as Claimant's Exhibit No. 2 which is the comparative balance sheets and comparative profit and loss statements of the years of the partnership, the opening balance sheet of the corporation, which is Objector's No. 3, and the other records, papers and documents of the corporation which were available to and examined by you?

A. Yes, that would be part of it.

Q. Will you tell the Court now what the opinion was that you gave the corporation and if your present opinion on the subject differs, give your present opinion as well, referring to the time of the incorporation?

A. We offered to them—my offer was because I had more to do with the fact that they incorporated than anyone else, I think—was that \$6,000.00 would be set up as a capital stock and that would be the investment in the business. The rest of [129] it was set up as a note payable which would be liquidated more by—out of profits and that would be the way it would go.

Q. And did you express an opinion as to whether or not the stated capital of \$6,000.00, having in mind the execution of corporate notes for the remainder of what had been the capital accounts of the partners, would with the other assets of the business be sufficient in your opinion for the corporation to carry on successfully? A. Yes.

Q. Now, Mr. Laborde, did you give any consideration in reaching that opinion to the financial ar-

(Testimony of Robert H. Laborde.)

rangements between the American Trust Company, the partnership and the proposed corporation and the members of the partnership?

A. Yes, that would be part of it. You have to take the whole thing as a whole.

Q. Now, were you personally familiar with the arrangements between Messrs. Fazio and Ambrose and the American Trust with respect to Leonard's?

A. Yes.

Q. Will you tell the Court what those arrangements were both before the incorporation and after the incorporation?

A. The Leonard Plumbing as a partnership and as a corporation—the credit of the Leonard Plumbing with the American Trust Company was secured by a continuing guaranty which was signed by Mr. and Mrs. Fazio and Mr. and Mrs. Ambrose and Mr. and Mrs. Leonard in the amount of \$75,000.00.

Q. Now, having in mind that that was a continuing available amount of credit under the circumstances that you have outlined [130] is it your testimony that that contributed to and was an element of what you considered to be a proper basis for working capital?

A. Yes, very definitely so.

Q. Does Exhibit 4, Mr. Laborde—do you still have it—I note on Exhibit 4—that's Objector's Exhibit 4, Mr. Laborde, three notes denominated 1, 2 and 3 above. Will you explain to the Court what those mean?

(Testimony of Robert H. Laborde.)

A. The profit was shared equally after the allowance of the salary to Mr. Leonard and the reason why there are three different notes is that those are three different annual salaries.

Q. In other words, your notes 1, 2 and 3 indicate two things, first, that the amount of profit credited or loss charged to the capital account of each of the three partners was computed after allowing salary to Mr. Leonard in accordance with the oral understanding which you testified about this morning and also it shows the amount of salary, the varying amounts of salary allowed to Mr.—and withdrawals by Mr. Leonard during the periods covered by those three notes, is that right? A. Yes.

Q. And I think you testified, if not, do so now, that neither Fazio nor Ambrose at any time drew any salary as such from the business, either the partnership or the corporation.

A. That's correct.

Q. Mr. Leonard continued to draw and did draw, did he not, a salary from the corporation after its formation? A. Yes.

Q. Do you know how much that was? [131]

A. \$790.00 a month.

Mr. Shapro: No further questions.

The Referee: Any further questions from the claimant Ambrose with reference to Mr. Laborde's direct? It would make it much more simpler.

Q. (By Mr. Chew): Mr. Laborde, I notice that as of the date September 30, 1952 your books showed

(Testimony of Robert H. Laborde.)

a loan from the partnership in the amount of \$4451.17. Is that not right?

A. Yes, that's right.

Q. Since the date of the incorporation, Mr. Laborde, has there been any change in that amount?

Mr. Walsh: Amount. What do you mean, Mr. Chew?

Q. That \$4451.17 which was due and outstanding to Mr. Ambrose as of the date of the incorporation.

A. Yes.

Q. And will you tell me what exactly happened?

A. On December 31, 1952, Mr. Fazio transferred \$2,000.00 share of his note to Mr. Ambrose which would have increased that Forty-four Hundred and December 31, 1953 transferred another \$2,000.00 to that note account. Then there was some minor drawings made by Mr. Ambrose against the total amount of \$8400.00. I think there was an automobile for \$400.00 and then there were one or two small cash payments.

Q. And the transfers from Mr. Fazio's note to Mr. Ambrose's note was noted in the books of the corporation, was it not? [132]

A. Yes.

Mr. Chew: That's all.

The Referee: Mr. Laborde, before counsel for the trustee takes on the examination, in answer to Mr. Shapro's question you stated in effect that the obligation due Mr. Ambrose and Mr. Fazio were going to be liquidated out of the profits of the corporation. Is that what you were saying?

The Witness: Well, that would be the under-

(Testimony of Robert H. Laborde.)

standing. In other words, as the company would go along, they would accumulate money and they would make payments against these notes.

The Referee: Well, then, the subject comes with reference to what the status would be if there was no profit.

The Witness: No——

The Referee: Forget bankruptcy.

The Witness: No, this is something that wasn't—that I had taken into account that they would pay these things as it went along. In other words, that there was no payment to be made in a week or something—as time went along they would receive money against their——

The Referee: Against their profits?

The Witness: Not directly as such against the profits. In other words, the profits would go to the business, you see, and then as the things went along they would pay [133] on the note.

Cross Examination

Q. (By Mr. Dole): If this concern, when it began a corporation, Mr. Laborde, had not paid the notes, given these notes to the two partners, Fazio and Ambrose, but had merely capitalized the same capital accounts of the partners and issued stock in like accounts or in like amounts, then any profits of the corporation would have been paid in the form of dividends, would they not?

A. There wouldn't have been any notes.

Q. That's right.

(Testimony of Robert H. Laborde.)

A. That would be the only way they could get their money out.

Q. And then that would be taxable. A. Yes.

Q. At the time you assisted these people in converting to a corporation and advised them to transfer the funds from these capital accounts into loans from the corporation to the partners did you advise them that in the event the corporation failed that their claims might be subordinated to those of other general creditors?

A. No, there never was any discussion on that.

Q. And you never undertook to advise them of that fact. A. (Witness nods negatively.)

Mr. Dole: I have no other questions.

The Referee: Mr. Shapro?

Mr. Shapro: No other questions.

The Referee: Is Mr. Laborde excused? [134]

Mr. Shapro: Yes.

The Referee: Thanks very much, Mr. Laborde.

Mr. Shapro: As far as the claimant Fazio is concerned, your Honor, we rest.

Mr. Chew: At this time, your Honor, I would like to make a motion to amend Mr. Ambrose's claim to conform with the proof as has been presented and—

The Referee: Do you know offhand what the change would be in figures?

Mr. Chew: No change in the figures, your Honor. It's just the statement of the consideration.

The Referee: No change in the figures.

Mr. Chew: No change in the figures. The orig-

inal note has been admitted into evidence so that we won't have to identify it at least.

The Referee: You have no objection.

Mr. Dole: No objection.

Mr. Walsh: No objection.

The Referee: The motion is granted.

Mr. Chew: The claimant Ambrose rests also.

The Referee: What is the desire of the objector and the claimant with reference to this matter on the submission?

Mr. Walsh: It stands submitted now except for submission of briefs.

Mr. Shapro: And that one exhibit you are going to [135] present.

Mr. Walsh: Yes.

The Referee: And it's stipulated that that exhibit be a part of the record.

Mr. Dole: It may.

The Referee: And the exhibit, as I understand, is the ledger sheet.

Mr. Walsh: We will introduce the entire ledger in evidence.

Mr. Dole: As far as that goes, I would not have introduced it now. Did you wish it to be introduced?

Mr. Shapro: No.

Mr. Dole: Then it doesn't have to——

Mr. Shapro: Then we'll forget about it. That's fine.

The Referee: Now, Mr. Walsh and Mr. Dole, how much time do you desire?

Mr. Dole: Thirty days.

The Referee: The claimant Ambrose and the claimant Fazio's time will start to run at the same time. In other words, when the trustee files his memorandum within thirty days, then each of the claimants will have thirty days to answer in—thirty and thirty. In other words, they will each reply.

Mr. Shapro: In other words, our thirties will run simultaneously. [136]

The Referee: That's right.

Mr. Shapro: But after the submission of the trustee's brief.

Mr. Crews: Sixty altogether.

Mr. Walsh: And fifteen days for reply.

Mr. Shapro: We haven't gotten that far.

The Referee: How much time do you want?

Mr. Dole: Fifteen will be adequate.

The Referee: Let the record show that the Court is retaining all of the exhibits.

[Endorsed]: Filed Sept. 18, 1956.

[Endorsed]: No. 15587. United States Court of Appeals For The Ninth Circuit. John Costello, Trustee in Bankruptcy of Leonard Plumbing and Heating Supply, Inc., bankrupt, Appellant, vs. J. A. Fazio and Lawrence C. Ambrose, Appellees. Transcript of Record. Appeal from the United States District Court for the Northern District of California, Southern Division.

Filed: June 10, 1957.

Docketed: June 18, 1957.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Court of Appeals for
the Ninth Circuit.

In The United States Court of Appeals
For The Ninth Circuit

No. 15587

JOHN COSTELLO, Trustee of the Estate of
LEONARD PLUMBING & HEATING SUP-
PLY, INC., a California corporation, bankrupt,
Appellant,

vs.

J. A. FAZIO and L. C. AMBROSE,

Appellees.

STATEMENT OF POINTS ON WHICH AP-
PELLANT INTENDS TO RELY ON AP-
PEAL

Pursuant to the rules of this Court, appellant

John Costello, trustee of the estate of Leonard Plumbing & Heating Supply, Inc., a California corporation, bankrupt, makes this statement of points on which he intends to rely in this appeal.

1. The District Court erred in affirming the order of the Referee in Bankruptcy overruling the Trustee's objections to the proofs of the claims of J. A. Fazio and L. C. Ambrose (Lawrence C. Ambrose).

2. The District Court erred in holding that there is substantial evidence in the record to sustain the findings of the Referee in Bankruptcy. In particular the District Court erred in holding that the first, fourth, fifth, sixth, seventh, ninth, tenth and eleventh findings contained therein are supported by the evidence.

3. The District Court erred in not finding that the proofs of the claims of J. A. Fazio and L. C. Ambrose (Lawrence C. Ambrose) if allowed at all, should be subordinated to those of other unsecured creditors.

4. The District Court erred in not finding that the obligations upon which the claims of J. A. Fazio and L. C. Ambrose (Lawrence C. Ambrose) were founded were conditional obligations to pay a debt out of an uncertain fund, which fund never came into existence.

5. The District Court erred in denying the relief prayed for in the Trustee's Objections to the Proofs

of Claims filed by J. A. Fazio and Lawrence C. Ambrose (L. C. Ambrose) herein.

Dated: June 24, 1957.

FRANCIS P. WALSH,
HENRY GROSS,
JAMES M. CONNERS,
STUART R. DOLE,

/s/ By FRANCIS P. WALSH,
Attorneys for Appellant John Costello, Trustee of
the Estate of Leonard Plumbing & Heating
Supply, Inc., a California corporation, Bank-
rupt.

[Title of Court of Appeals and Cause.]

DESIGNATION OF ALL OF THE RECORD
WHICH IS MATERIAL TO THE CONSID-
ERATION OF THE APPEAL

Comes now John Costello, Trustee of the estate of Leonard Plumbing & Heating Supply, Inc., a California corporation, bankrupt, appellant in the above entitled cause, and states that the parts of the record as docketed in the above court deemed necessary to the consideration of the appeal herein are as follows:

1. The entire transcript of the record, proceedings and evidence set out in the Referee's Certificate on Petition for Review of Order Overruling Trustee's Objections to Proofs of Claim of J. A. Fazio and Lawrence C. Ambrose (L. C. Ambrose),

said certificate being dated the 6th day of February 1957, and filed with the District Court on the 7th day of February, 1957.

2. The original documents transmitted with the Certificate on Review.

3. The order of the District Court dated April 11, 1957, affirming said Referee's order; and Notice of Appeal.

4. This designation.

Dated: June 24, 1957.

FRANCIS P. WALSH,
HENRY GROSS,
JAMES M. CONNERS,
STUART R. DOLE,

/s/ By FRANCIS P. WALSH,
Attorneys for Appellant John Costello, Trustee of
the Estate of Leonard Plumbing & Heating
Supply, Inc., a California corporation, bank-
rupt.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed June 25, 1957. Paul P.
O'Brien, Clerk.

